S. HRG. 98-422

MORATORIUM LEGISLATION AND FINANCIAL INSTITUTIONS DEREGULATION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1532

TO LIMIT TEMPORARILY THE ACQUISITION OF DEPOSITORY INSTITUTIONS AND THE COMMENCEMENT OF CERTAIN NEW ACTIVITIES BY STATE-CHARTERED DEPOSITORY INSTITUTIONS AND FOR OTHER PURPOSES

S. 1609

TO AUTHORIZE DEPOSITORY INSTITUTION HOLDING COMPANIES TO ENGAGE IN ACTIVITIES OF A FINANCIAL NATURE, INSURANCE UNDERWRITING AND BROKERAGE, REAL ESTATE DEVELOPMENT AND BROKERAGE, AND CERTAIN SECURITIES ACTIVITIES INCLUDING DEALING IN, UNDERWRITING AND PURCHASING GOVERNMENT AND MUNICIPAL SECURITIES, SPONSORING AND MANAGING INVESTMENT COMPANIES AND UNDERWRITING THE SECURITIES THEREOF, TO PROVIDE FOR THE SAFE AND SOUND OPERATION OF DEPOSITORY INSTITUTIONS, TO AMEND THE FEDERAL RESERVE ACT, THE HOME OWNERS' LOAN ACT OF 1933, AND THE BANK SERVICE CORPORATION ACT, AND FOR OTHER PURPOSES

S. 1682

TO REDEFINE "BANK" FOR PURPOSES OF APPLICATION OF THE BANK HOLDING COMPANY ACT OF 1956, TO EQUATE UNITARY SAVINGS AND LOAN HOLDING COMPANY AND MULTIPLE SAVINGS AND LOAN HOLDING COMPANY ACTIVITIES, AND TO APPLY THE PROVISIONS OF THE GLASS-STEAGALL ACT EQUALLY TO INSURED DEPOSITORY INSTITUTIONS

JULY 18, SEPT. 13, 14, 1983

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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MORATORIUM LEGISLATION AND FINANCIAL INSTITUTIONS DEREGULATION

MONDAY, JULY 18, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., in room SD–538, of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Gorton, Mattingly, Hecht, Trible, and Riegle:

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

The Secretary of Treasury is not quite here yet. I understand he's on his way, but as you know, for the last 3 years, I have had myself trapped into a position where I said that the Banking Committee would never start late as long as I was chairman, so we start even if the witnesses are not here.

Today we begin hearings on legislation to deal with many of the issues regarding changes in the financial system which were raised and discussed during the committee's recent oversight hearings on the financial services industry.

The principal focus of these hearings will be on the administration's comprehensive Financial Institutions Deregulation Act, S. 1609; and the Federal Reserve's nonbank bank moratorium bill, S. 1532.

[Copies of bills being considered follow:]

98TH CONGRESS
1ST SESSION

S. 1532

To limit temporarily the acquisition of depository institutions and the commencement of certain new activities by State-chartered depository institutions and for other purposes.

IN THE SENATE OF THE UNITED STATES

JUNE 23 (legislative day, JUNE 20), 1983

Mr. GARN (by request) (for himself, Mr. HEINZ, Mr. PROXMIRE, and Mr. DODD) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To limit temporarily the acquisition of depository institutions and the commencement of certain new activities by State-chartered depository institutions and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. The effective date of this Act is the date of its enactment and this Act is hereby repealed on December 31, 1983.

SEC. 2. On or after the effective date of this Act, no company that is engaged directly or indirectly, including through a subsidiary, in any activity not permitted for a bank holding company under section 4 of the Bank Holding Company Act shall acquire control of any insured bank, and no company shall acquire control of insured banks in more than one State without prior approval under the Bank Holding Company Act.

SEC. 3. On or after the effective date of this Act, no company that is engaged directly or indirectly, including through a subsidiary (other than an insured institution), in any activity other than an activity permitted for a multiple savings and loan holding company on the effective date of this Act under subsection (c)(2) of section 408 of the National Housing Act or for a bank holding company under section 4 of the Bank Holding Company Act shall acquire control of any insured institution, except as provided in subsection (m) of section 408 of the National Housing Act.

SEC. 4. No company that acquires or acquired control of an insured bank or insured institution on or after June 23, 1983, shall retain control of such bank or institution on or after the effective date of this Act and engage directly or indirectly, including through a subsidiary (other than an insured institution), in any activity other than an activity permitted for a bank holding company under section 4 of the Bank Holding Company Act or for a multiple savings and loan holding company under subsection (c)(2) of section 408 of the National Housing Act, unless such insured institution was acquired pursuant to subsection (m) of section 408 of the

National Housing Act. After the effective date of this Act, no company shall retain control of insured banks in more than one State that were acquired on or after June 23, 1983, unless such banks were acquired with prior approval under the Bank Holding Company Act.

SEC. 5. On or after the effective date of this Act, no State-chartered depository institution may commence, either directly or indirectly, including through a subsidiary, any activity not previously and lawfully engaged in by that institution unless (a) such activity was authorized for that type of institution explicitly and not by implication by a State statute adopted, or by interpretation promulgated thereunder, prior to January 1, 1983; (b) such activity is permitted under section 4(c)(8) of the Bank Holding Company Act for a bank holding company; or (c) such activity is explicitly authorized by a State statute, or interpretation promulgated thereunder, and is performed exclusively in the State authorizing such activity for customers present in that State: *Provided, however,* That this section does not authorize the conduct of any activity currently prohibited to State-chartered depository institutions under section 20 or 21 of the Glass-Steagall Act. Nothing in this section shall prohibit a State-chartered savings and loan association or savings bank from engaging in any activity expressly permitted for a Federal savings and loan association or savings bank under the Garn-St Germain Depository Institutions Act of 1982.

SEC. 6. Any State-chartered depository institution that commenced, directly or indirectly, including through a subsidiary, on or after June 23, 1983, any activity that would have been prohibited by this Act if commenced after enactment of this Act shall, upon enactment of this Act, immediately terminate such activity.

SEC. 7. The provisions of this Act shall be enforced by the appropriate Federal agency under the Financial Institutions Supervisory Act of 1966, as amended, and for this purpose any company that controls an insured bank shall be treated as a bank holding company.

SEC. 8. For purposes of this Act, the terms—

(a) "bank holding company", "company", "control", and "subsidiary" have the same meanings as provided in section 2 of the Bank Holding Company Act;

(b) "depository institution" has the same meaning as provided in section 461(b) of title 12, United States Code;

(c) "insured bank" has the same meaning as provided in section 1813(h) of title 12, United States Code, and shall also include any institution that is eligible to become an insured bank under section 1815 of title 12, United States Code, and any institution that accepts deposits that the depositor may withdraw by check or similar means for payment to third parties and engages in the business of making commercial loans. The term "bank" does not include any foreign bank having an insured branch or an institution expressly exempted under section 2(c) of the Bank Holding Company Act; and

(d) "insured institution" and "multiple savings and loan holding company" have the same meanings as provided in section 408 of the National Housing Act.

○

II

98TH CONGRESS
1ST SESSION

S. 1609

To authorize depository institution holding companies to engage in activities of a financial nature, insurance underwriting and brokerage, real estate development and brokerage, and certain securities activities including dealing in, underwriting and purchasing government and municipal securities, sponsoring and managing investment companies and underwriting the securities thereof, to provide for the safe and sound operation of depository institutions, to amend the Federal Reserve Act, the Home Owners' Loan Act of 1933, and the Bank Service Corporation Act, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 12 (legislative day, JULY 11), 1983

Mr. GARN (for himself and Mr. PROXMIRE) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To authorize depository institution holding companies to engage in activities of a financial nature, insurance underwriting and brokerage, real estate development and brokerage, and certain securities activities including dealing in, underwriting and purchasing government and municipal securities, sponsoring and managing investment companies and underwriting the securities thereof, to provide for the safe and sound operation of depository institutions, to amend the Federal Reserve Act, the Home Owners' Loan Act of 1933, and the Bank Service Corporation Act, and for other purposes.

INTENTIONAL
BLANK

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Financial Institutions Deregulation Act".

AMENDMENTS TO THE BANKING ACT OF 1933

SEC. 2. Section 20 of the Banking Act of 1933, as amended (12 U.S.C. 377), is hereby amended by adding the following new paragraph at the end of the first paragraph of such section:

"Notwithstanding any other provision of this section, a member bank may be affiliated in any manner described in subsection (b) of section 221a of this title with a depository institution securities affiliate as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).".

SEC. 3. Section 32 of the Banking Act of 1933, as amended (12 U.S.C. 78), is hereby amended by adding the following sentence at the end of the first paragraph of such section: "Notwithstanding any other provision of this section, an officer, director, or employee of any member bank may serve at the same time as an officer, director, or employee of any of its depository institution securities affiliates. The term 'depository institution securities affiliate' shall have the meaning ascribed to it in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)).".

AMENDMENTS TO THE SECURITIES ACT OF 1933

SEC. 4. Section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77d), is hereby amended adding a new paragraph (7) at the end thereof:

"(7) Transactions involving offers or sales of equity securities, in connection with the acquisition of a bank by a company under the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.), or in connection with the acquisition of an insured institution by a company under the Savings and Loan Holding Company Amendments of 1967, as amended (12 U.S.C. 1730a), if such acquisition occurs solely as part of a reorganization in which a person or group of persons exchange their shares of a bank or insured institution for shares of a newly formed bank holding company or savings and loan holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank or insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State law.".

AMENDMENTS TO THE SECURITIES EXCHANGE ACT

SEC. 5. Subparagraphs (i), (ii), and (iii) of paragraph (34)(A) of subsection 3(a) of the Securities Exchange Act of

1934, as amended (15 U.S.C. 78c(a)(34)(A)), are each hereby amended by inserting immediately before the semicolons at the end thereof, the words, "other than a depository institution securities affiliate as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)) or as defined in section 408(a)(1)(K) of the National Housing Act (12 U.S.C. 1730a(a)(1)(K))".

SEC. 6. Paragraph (b)(1), section 15B of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78o–4(b)(1)), is hereby amended by striking the word "subsidiaries" in parts (B) and (C) thereof and replacing it with the word, "affiliates".

AMENDMENTS TO THE BANK HOLDING COMPANY ACT

SEC. 7. Section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841), is hereby amended—

(1) by amending subsection (c) to read as follows:

"(c) 'Bank' means (1) an 'insured bank' as that term is defined in section 1813(h) of this title; (2) any institution that is eligible to become an insured bank under section 1815 of this title; or (3) any institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands, that accepts deposits that the depositor may withdraw by check or similar means for payment to third parties and is engaged in the business of making commercial loans. The term 'bank' does not include (A) any foreign bank having an insured branch; (B) an insured institution; (C) any organization operating under section 25 or section 25(a) of the Federal Reserve Act; or (D) any organization that does not do business in the United States except as an incident to its activities outside the United States."; and

(2) by inserting after subsection (i) the following new subsections:

"(j) The term 'depository institution securities affiliate' means any corporation that (a) is engaged in the United States in one or more of the activities authorized pursuant to subsection 4(c)(15) of this Act, and (b) is a broker or dealer within the meaning of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a) (4) and (5)), or an investment adviser within the meaning of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(11)). For purposes of this chapter, a corporation engaged in any such activities shall be deemed to be a depository institution securities affiliate only so long as it is a bank holding company or is owned or controlled by a bank holding company.

"(k) For purposes of this chapter—

"(1) the term 'depository institution holding company' means bank holding company;

"(2) the term 'depository institution' means bank; and

"(3) the terms 'savings and loan holding company' and 'insured institution' have the meanings ascribed to them in section 1730a(a)(1) of this title.".

SEC. 8. Subsection 3(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(a)), is hereby amended by adding the following immediately preceding the period at the end of the second sentence of such subsection: "; or (C) with thirty days prior notification to the Board, the acquisition by a company of control of a bank in a reorganization in which a person or group of persons exchange their shares of the bank for shares of a newly formed bank holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the bank except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State law: *Provided,* That, immediately following such acquisition, the bank holding company meets the capital and other financial standards prescribed by the Board by regulation for such a bank holding company and the holding company does not engage in any activities other than those of banking or managing and controlling banks. In promulgating regulations pursuant to this subsection, the Board shall not require more capital for the subsidiary bank immediately following the reorganization that is required for a similarly sized bank that is not a subsidiary of a bank holding company.".

SEC. 9. Subsection 4(a)(2) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(a)(2)), is hereby amended to read as follows—

(1) by amending subparagraph (B) of such subsection to read as follows—

"(B) those permitted under paragraphs (8) (except for those of an insured institution), (15) and (16) of subsection (c) of this section subject to all the conditions and requirements specified in each respective paragraph or in any order or regulation issued by the Board under such paragraphs"; and

(2) by adding the following additional proviso at the end of such subsection: *Provided further*, (I) That the two-year period referred to in this paragraph shall not apply to a company that becomes a bank holding company as a result of enactment of the Financial Institutions Deregulation Act and that acquired a bank between July 1, 1983, and the effective date of such Act; and (II) That a company that becomes a bank holding company as a result of the enactment of the Financial Institutions Deregulation Act, and that con-

trolled an insured bank on July 1, 1983, may engage in any activity in which it was lawfully engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983: *Provided,* That any activities authorized for bank holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions, and limitations applicable to bank holding companies. The authority conferred by the preceding clause (II): (a) shall terminate at such time as (1) any covered bank holding company acquires control of an additional bank or an insured institution, (2) its existing subsidiary bank commences accepting deposits that the depositor has a legal right to withdraw on demand and engages in the business of making commercial loans, or (3) any covered bank holding company commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those activities authorized pursuant to this Act (except for the acquisition of an insured institution), in which it was not engaged on July 1, 1983; and (b) may be terminated by the Board by order, after opportunity for hearing, if it determines, having due regard to the purposes of this chapter, that such action is necessary to prevent conflicts of interests or unsound banking practices or is in the public interest.".

SEC. 10. Paragraph 8 of subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(8), is hereby amended to read as follows—

"(8)(A) in accordance with the limitations and requirements contained in subparagraph (B) of this paragraph, shares of any insured institution or shares of any company the activities of which consist of—

"(i) activities that the Board has determined (by order or regulation) to be closely related to banking or managing or controlling banks or (by regulation) to be of a financial nature;

"(ii) insurance underwriting or brokerage; or

"(iii) real estate investment, development or brokerage: *Provided*, That, in the case of real estate investment and development, the percentage of a bank holding company's capital that may be devoted to this activity shall not exceed 5 per centum of such company's primary capital.

"(B)(i) No bank holding company shall engage in any activity authorized under this paragraph either de novo or by an acquisition in whole or in part of a going concern, unless the Board has been given sixty days prior written notice of such proposal and, within such period, the Board has not issued an order (1) disapproving the proposal or (2) suspending the time period in accordance with clause (iii) below.

"(ii) An acquisition may be made prior to the expiration of the disapproval period if the Board issues a written notice of its intent not to disapprove the action. The Board may provide for no notice under this paragraph or notice for a shorter period of time with respect to particular activities. No notice under this paragraph is required in the event a bank holding company establishes de novo an office to engage in any activity previously authorized for such a bank holding company under this paragraph or changes the location of an office engaged in such activity.

"(iii) The notice submitted to the Board shall contain such information as the Board shall prescribe by regulation or by specific request in connection with a particular notice: *Provided, however,* That the Board may only require such information as may be relevant to the nature and scope of the proposed activity and to the Board's evaluation of the criteria provided for in clause (iv) hereof. In the event the Board requires additional relevant information beyond that provided in the notice submitted pursuant to this paragraph, the Board may by order suspend the time period provided in clause (i) hereof until it has received such additional relevant information, and the activity that is the subject of the notice may be commenced within thirty days of the date of such receipt unless the Board issues a disapproval order as provided in clause (i) hereof. Such a suspension order is reviewable under section 9 of this Act.

"(iv) In connection with a notice under this paragraph, the Board may consider the following criteria—

"(I) the managerial resources of the companies involved;

"(II) the adequacy of their financial resources, including their capital, giving consideration to the financial resources and capital of others engaged in similar activities: *Provided*, That the Board shall not require a higher level of capital for any activity subject to Federal or State regulation than would be required by the applicable regulatory authority for a company engaged in such activity, unless the Board shall find that particular circumstances warrant a higher level of capital;

"(III) any practice or arrangement that may adversely affect the independence or impartiality of an affiliated bank in the provision of credit or other services or the terms on which such credit and services are made available, or the availability of such credit; and

"(IV) any material adverse effect on the safety and soundness or financial condition of an affiliated bank or banks.

"(v) The Board shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Board order determining not to disapprove a proposal to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this Act or in any other manner: *Provided, however,* That any bank holding company may obtain judicial review pursuant to section 9 of this Act of any Board order not to disapprove a notice under this paragraph if such order contains restrictions or conditions.

"(vi) The Board shall, within one hundred and eighty days of enactment of the Financial Institutions Deregulation Act and from time to time thereafter, promulgate regulations under this paragraph designating particular activities that are closely related to banking or of a financial nature. A bank holding company may petition the Board to determine by regulation that a particular activity is closely related to banking or of a financial nature. The Board may by regulation prescribe limitations on the conduct of any activity or activities authorized under paragraphs (8), (15), and (16) of this subsection consistent with the criteria in subparagraph (B)(iv) hereof and with safe and sound financial practices. In administering this paragraph, the Board shall promote competition between bank holding companies and all other companies engaged in activities of a financial nature or closely related to banking.

"(vii) The regulation required under clause (vi) of this paragraph shall include any activity determined by the Board by regulation prior to enactment of this Act to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Board shall not designate as an activity of a financial nature or closely related to banking within the meaning of this paragraph any activity that is described in paragraph (15) of this subsection or that is prohibited to a member bank or an affiliate of a member bank under sections 16 (12 U.S.C. 24 (Seventh)) or 20 (12 U.S.C. 377) of the Banking Act of 1933, as amended.".

SEC. 11. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)), is hereby amended by deleting the penultimate sentence thereof and by adding a new paragraph (15) as follows—

"(15) shares of any depository institution securities affiliate engaged in activities in accordance with the limitations contained in this paragraph:

"(i) No depository institution holding company that establishes or acquires any depository institution securities affiliate pursuant to this paragraph shall, after one year from the date on which any such depository institution securities affiliate first engages in any of the activities authorized under subparagraph (iii) of this paragraph, permit any depository institution controlled by such depository institution holding company to engage, directly or through a subsidiary, in the United States in any of the activities authorized under such subparagraph (iii) of this paragraph or any of the following activities, which are authorized pursuant to paragraph Seventh of section 5136 of the Revised Statutes of the United States, as amended (12 U.S.C. 24): dealing in and underwriting obligations of the United States, general obligations of any State of the United States or any political subdivision thereof and other obligations listed in paragraph Seventh of such section 5136 and purchasing and selling securities and stock as agent. For purposes of this paragraph, the Board may, by regulation or order, determine other securities or securities-related activities in which depository institutions may not engage. No rule, regulation or order of the Board, however, shall prohibit a depository institution from engaging in those securities or securities-related activities that are necessary or incidental to the financing of such depository institution or the investment of its funds. In the event that a depository institution holding company terminates all of the activities specified in subparagraph (iii) of this paragraph of its depository institution securities affiliate, any depository institution subsidiary of such holding company may conduct, directly or through a subsidiary, any securities or securities-related activities that it is authorized by law to conduct.

"(ii) Any depository institution securities affiliate may conduct any securities or securities-related activity that a national banking association, as such term is used in section 21 of this title, is not prohibited from conducting.

"(iii) In addition to the activities referred to in subparagraphs (i) and (ii) of this paragraph, such depository institution securities affiliate may—

"(A) deal in and underwrite all obligations issued or guaranteed by or on behalf of a State or any political subdivision thereof or any agency or instrumentality of either of the foregoing, except industrial development bonds as defined in section 103(b)(2) of the Internal Revenue Code of 1954, as amended: *Provided, however,* That depository institution securities affiliates may deal in and underwrite such industrial development bonds, the interest on which is exempt from Federal income tax under section 103(a) of the Internal Revenue Code of 1954, as amended, if: (i) a State, territory, possession of the United States, or any political subdivision of the foregoing, or the District of Columbia pledges its full faith and credit for the payment of all principal and interest on such bonds or (ii) the issuer, or the State or local governmental unit on behalf of which the industrial development bonds were issued, is considered the sole owner, for Federal income tax purposes, of the facility with respect to which financing is to be provided from the proceeds of such industrial development bonds;

"(B) organize, sponsor, operate, and control an investment company, as such term is defined in section 3 of the Investment Company Act of 1940, as amended;

"(C) render investment advice to: (1) an investment company as described in subparagraph (B) above; and (2) any investment company other than a closed-end investment company;

"(D) underwrite, distribute, and sell securities of any investment company, as such terms are defined in section 3 of the Investment Company Act of 1940, as amended.

"(iv) A bank holding company seeking to acquire shares of a depository institution securities affiliate or engage directly in securities or securities-related activities pursuant to this paragraph shall comply with the notice and other requirements of clauses (i) through (vi) of paragraph (8)(B) of this subsection.".

SEC. 12. Section 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)), is hereby amended by adding new paragraph (16) to read as follows—

"(16) shares of any company engaged in any activity in which a multiple savings and loan holding company was authorized by law or regulation to engage directly on July 1, 1983: *Provided, however,* That the activities of real estate investment and development may only be engaged in within the limitations of clause (iii) of subparagraph 4(c)(8)(A) of this Act: *And Provided further,* That any conditions and limitations applicable to a savings and loan company with respect to such activities shall likewise be applicable to such a bank holding company, except that a bank holding company seeking to acquire shares of such a company pursuant to this paragraph shall comply with the notice and other requirements of clauses (i) through (vi) of paragraph (8)(B) of this subsection and except that the Board may by regulation prohibit any bank holding company from engaging in such activities or limit their conduct.".

SEC. 13. Subsection 5(c) of the Bank Holding Company Act, as amended (12 U.S.C. 1844(c)), is hereby amended to read as follows:

"(c)(1) The Board from time to time may require reports under oath, in such scope and detail as it may determine, of a bank holding company and each subsidiary thereof to keep the Board informed as to whether such companies are complying with the provisions of this chapter and regulations and orders issued thereunder.

"(2) Except where the Board determines that a lesser reporting requirement is appropriate, the Board shall accept in fulfillment of the reporting requirements established by this subsection for nonbank subsidiaries separate reports consisting of: (A) for companies subject to the reporting requirements of section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q), the same information required to be submitted to the Securities and Exchange Commission under such section (and the rules and regulations thereunder) at the same time such information is so submitted; and (B) for all other companies, the same information as would be required to be submitted under section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) (and the rules and regulations thereunder) by companies subject to the reporting requirements of such Act, that are engaged in the same or similar lines of business, not more frequently than quarterly. In particular circumstances, the Board may require additional information in order to fulfill its responsibilities under this Act.

"(3) The Board may make examinations of each bank holding company and each subsidiary thereof, the cost of which may be assessed against, and paid by, such holding company. The Board shall, however, insofar as possible, minimize the scope and frequency of examinations of nonbank subsidiaries of a bank holding company by utilizing, where feasible, reports of applicable regulatory agencies or other bodies public or private, and by directing, to the extent feasible, the focus of such examinations to the activities or financial condition of such nonbank subsidiaries that may have a materially adverse effect on the safety and soundness or financial condition of a subsidiary bank of the bank holding company.".

SEC. 14. Section 7 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1846), is hereby amended by striking out the period at the end thereof and inserting in lieu thereof ": *Provided, however,* That no State shall prohibit the affiliation of a national banking association, as such term is used in section 21 of this title, with a company engaged only in one or more of the activities described in paragraphs (8), (15), and (16) of subsection 4(c) of this Act.".

AMENDMENTS TO THE FEDERAL RESERVE ACT

SEC. 15. (a) The Federal Reserve Act is amended by adding new section 23B immediately following section 23A (12 U.S.C. 371c) thereof to read as follows:

"SEC. 23B. RESTRICTIONS ON TRANSACTIONS WITH AFFILIATES.—(a) A member bank and its subsidiaries may engage in any of the following transactions, only on terms and under circumstances, including credit standards, that are substantially the same as, or at least as favorable to such bank or its subsidiary as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to nonaffiliated companies—

"(1) any covered transaction, as defined in section 23A, with an affiliate;

"(2) the sale of securities or other assets, including assets subject to an agreement to repurchase, to an affiliate;

"(3) the payment of money or the furnishing of services to an affiliate, under contract, a lease, or otherwise;

"(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person; or

"(5) any transaction or series of transactions with a third party, (A) if an affiliate has a financial interest in the third party, or (B) if an affiliate is a participant in such transaction or series of transactions.

For the purposes of this subsection, any transaction by a member bank with any person shall be deemed to be a transaction with an affiliate of such bank to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, such affiliate.

"(b) A member bank and the affiliates of such bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates; however, a member bank and its affiliates may use similar names.

"(c) A member bank and any subsidiary of such bank—

"(1) shall not purchase as fiduciary any securities or other assets from any affiliate unless such purchases are permitted under the instrument creating the fiduciary relationship, by court order, or by law of the jurisdiction under which the trust is administered; and

"(2) whether acting as principal or fiduciary, shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliate of such bank; except that this prohibition shall not apply where the purchase of such securities has been approved, prior to the time at which such securities are initially offered for sale to the public, by a majority of the directors of the bank who are not officers or employees of the bank or any affiliate thereof.

For the purpose of this paragraph, the term 'security' means a 'security' as defined in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)); and the term 'principal underwriter' means any underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer; (B) acting alone or in concert with one or more persons, initiates or directs the formation of an underwriting syndicate; or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

"(d) For the purpose of the section—

"(1) the term 'affiliate' means an 'affiliate' as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c) excluding a bank; and

"(2) the terms 'bank', 'subsidiary', 'person', and 'security' (other than security as used in subsection (c)) have the same meanings given to them in section 23A of the Federal Reserve Act (12 U.S.C. 371c).".

"(e) The Board may prescribe rules and regulations to administer and carry out the purposes of this section, including rules or regulations to (1) further define terms used in this section; (2) exempt transactions or relationships from the requirements of this section; or (3) exclude from the definition of 'affiliate' in this section any subsidiary of a bank holding company, if the Board finds such exemptions or exclusions to be in the public interest and consistent with the purposes of this section.".

(b) Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) is hereby amended—

(1) by inserting "and section 23B" after "section 23A" at each place it appears in paragraph (1); and

(2) by inserting ", 23B," after "23A" in paragraph (3)(A).

AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

SEC. 16. (a) Subsection 17(f) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a–17(f)), is hereby amended by adding after the words "unit investment trusts": "*Provided, however,* That any registered management company which is organized, sponsored, operated or controlled by, or which receives investment advice from, any depository institution securities affiliate, as defined in section 2(j) of the Bank Holding Company Act of 1956, as amended (12 U.S.C.

1841(j)) or in subsection (a)(1)(K) of the Savings and Loan Holding Company Act Amendments of 1967, as amended (12 U.S.C. 1730a(a)(1)(K)), may place and maintain its securities and similar investments in the custody of a bank which is affiliated with such depository institution securities affiliate only with the prior approval of the Commission.".

(b) Subsection 26(a)(1) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a–26(a)(1)), is hereby amended by adding after the words "so published);": "*Provided, however,* That, except with the prior approval of the Commission, it shall be unlawful for such trust indenture, agreement of custodianship, or other instrument to designate as trustee or custodian any bank which is affiliated with a depository institution securities affiliate, as defined in the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(j)) or in subsection (a)(1)(K) of the Savings and Loan Holding Company Act Amendments of 1967, as amended (12 U.S.C. 1730a(a)(1)(K)), which organizes, sponsors, operates or controls such registered unit investment trust.".

(c) Subsection 27(c)(2) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a–27(c)(2)), is hereby amended by adding after the words "trust indentures of unit investment trusts": "*Provided, however,* That, except with the prior approval of the Commission, it shall be unlawful to deposit such proceeds with any bank which is affiliated with a depository institution securities affiliate, as defined in section 2(j) of the Bank Holding Company Act of 1956 as amended (12 U.S.C. 1841(j)) or in subsection (a)(1)(K) of the Savings and Loan Holding Company Act Amendments of 1967, as amended (12 U.S.C. a(a)(1)(K), which organizes, sponsors, operates, controls or renders investment advice to such registered investment company.".

AMENDMENTS TO BANK HOLDING COMPANY ACT AMENDMENTS OF 1970

SEC. 17. Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972, et seq.) is hereby amended by adding new subsection (i) at the end thereof to read as follows:

"ACTIONS AUTHORIZED TO BE COMMENCED BY TRADE ASSOCIATIONS

"Any action for injunctive relief that may be commenced by any person pursuant to section 1976 of this title, may be commenced on the behalf of such person by any trade association of which such person is a member: *Provided,* That any such action commenced by a trade association shall be subject to the same requirements, limitations, and conditions as would be applicable had such action been commenced by any such person pursuant to section 1976 of this title.".

AMENDMENTS TO THE SAVINGS AND LOAN HOLDING COMPANY AMENDMENTS OF 1967

SEC. 18. Subsection (a)(1) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(a)(1)) is hereby amended by adding the following new subparagraphs (K) and (L) after subparagraph (J) of such subsection—

"(K) the term 'depository institution securities affiliate' means any corporation that (a) is engaged in the United States in one or more of the activities authorized for depository institution securities affiliates pursuant to subsection 4(c)(15) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(15)) and subject to the limitations specified therein, and (b) is a broker or dealer within the meaning of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a) (4) and (5)), or an investment adviser within the meaning of the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-2(11)). For purposes of this chapter, a corporation engaged in any such activities shall be deemed to be a depository institution securities affiliate only so long as it is owned or controlled by a savings and loan holding company. For purposes of applying paragraph 4(c)(15) of the Bank Holding Company Act to this chapter—

"(i) the term 'depository institution holding company' means savings and loan holding company; and

"(ii) the term 'depository institution' means 'insured institution.'

"(L) the terms 'bank holding company' and 'bank' shall have the meanings ascribed to them in section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841).".

SEC. 19. Subsection (c) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(c)) is hereby amended to read as follows:

"(c)(1) Except as otherwise provided in this subsection, no savings and loan holding company (except a unitary savings and loan holding company that acquires an insured institution pursuant to subsection (m) of this section) or subsidiary thereof which is not an insured institution shall—

"(A) for or on behalf of such subsidiary insured institution, engage in any activity or render any service for the purposes or with the effect of evading law or regulation applicable to such insured institution; or

"(B) commence or continue, after two years from the date as of which it becomes a savings and loan holding company, any business activity other than those specified in paragraph (2) of this subsection except that such two-year period shall not apply to any company that acquires an insured institution between July 1, 1983, and the effective date of the Financial Institutions Deregulation Act: *Provided,* That any company that becomes subject, as a result of the Financial Institutions Deregulation Act, to the prohibitions of this subparagraph and that controlled an insured institution prior to July 1, 1983, may engage in any activity in which it was lawfully engaged, directly or through a subsidiary, on July 1, 1983, and in which it has been engaged continuously since July 1, 1983: *Provided,* That any activities authorized for savings and loan holding companies may not be expanded and any additional activities may not be commenced except in accordance with the requirements, conditions, and limitations applicable to savings and loan holding companies. The authority conferred by the preceding proviso, (A) shall terminate at such time as any covered savings and loan holding company (i) acquires a bank, or its subsidiary insured institution fails to qualify as a domestic building and loan association under section 7701(a)(19) of the Internal Revenue Code of 1954, or (ii) commences, directly or through a subsidiary, after July 1, 1983, any additional activities, other than those authorized pursuant to this Act to be permissible for savings and loan holding companies (except for the acquisition of a bank), in which it was not engaged on July 1, 1983, or (B) may be terminated by the Corporation, after opportunity for hearing, if it determines, having due regard for the purposes of this chapter, that such action is necessary to prevent conflicts of interests, unsound practices, or in the public interest.

"(2) The prohibitions of subparagraph (1)(B) of this subsection shall not apply to the following business activities—

"(A) furnishing or performing management services for a subsidiary insured institution;

"(B) conducting an insurance agency or escrow business;

"(C) holding or managing or liquidating assets owned or acquired from a subsidiary insured institution;

"(D) holding or managing properties used or occupied by a subsidiary insured institution;

"(E) acting as trustee under deed of trust;

"(F) acquiring shares of any bank and engaging in one or more of the following activities subject to the limitations, conditions, and requirements specified in paragraph (3) of this subsection: (i) activities determined by the Board of Governors of the Federal Reserve System (by regulation) to be of a financial nature or closely related to banking or managing or controlling banks: *Provided, however,* That the Corporation may (by regulation) prohibit or limit any such activity for savings and loan holding companies; (ii) activities in which multiple savings and loan holding companies were authorized (by regulation) to engage directly on July 1, 1983: *Provided, however,* That in the case of real estate investment and development, savings and loan holding companies may only maintain investments lawfully held on July 1, 1983, and make additional investments within the limitations of clause (iv) hereof; (iii) engaging in either or both the activities of insurance underwriting and brokerage; (iv) engaging in one or more of the activities of real estate investment, development, or brokerage: *Provided,* That, in the case of real estate investment and development, the percentage of a savings and loan holding company's capital that may be devoted to this activity shall not exceed 5 per centum of such company's primary capital; and (v) engaging in the activities of a depository institution securities affiliate in accordance with the terms under which such activity may be conducted pursuant to the provisions of paragraph (15) of subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(15)); and

"(G) acquiring shares of any company which is an export trading company, as that term is defined in paragraph (14) of subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)(14)), and subject to all the requirements, conditions, and limitations of such paragraph (14) as if the acquiring or establishing savings and loan holding company were a bank holding company within the meaning of that paragraph, except that any notice required to be given pursuant to that paragraph shall be given to the Corporation, which shall have the same authority with respect to such notice procedure for savings and loan holding companies as the Board of Governors of the Federal Reserve System has pursuant to such paragraph (14).

"(3)(A) No savings and loan holding company shall engage, either de novo or by an acquisition, in whole or in part, of a going concern, in any activity authorized under subparagraph 2(F) of this subsection unless the Corporation has been given sixty days' prior written notice of such proposal and, within such period, the Corporation has not issued an order disapproving the proposal or extending for up to an additional thirty days the period within which such a disapproval may be issued.

"(B) An acquisition may be made prior to the expiration of the disapproval period if the Corporation issues a written notice of its intent not to disapprove the action. The Corporation may provide for no notice under this paragraph or notice for a shorter period of time with respect to particular activities. No notice under this paragraph is required in the event a savings and loan holding company establishes de novo an office to engage in any activity previously authorized for such savings and loan holding company under this paragraph or changes the location of an office engaged in such activity.

"(C) The notice submitted to the Corporation shall contain such information as the Corporation shall prescribe by regulation for the notice or by specific request in connection with a particular notice: *Provided, however,* That the Corporation may only require such information as may be relevant to the nature and scope of the proposed activity and to the Corporation's evaluation of the criteria provided for in subparagraph (D) hereof. In the event the Corporation requires additional relevant information beyond that provided in the notice submitted pursuant to this paragraph, the Corporation may by order suspend the time period provided in subparagraph (A) of this paragraph until it has received such additional relevant information, and the activity that is the subject of the notice may be commenced within thirty days of the date of such receipt unless the Corporation issues a disapproval order as provided in such subparagraph (A). Such suspension order is reviewable under subsection (k) of this section.

"(D) In connection with a notice under this paragraph, the Corporation may consider the following criteria—

"(i) the managerial resources of the companies involved;

"(ii) the adequacy of their financial resources, including their capital, giving consideration to the financial resources and capital of others engaged in similar activities: *Provided,* That the Corporation shall not require a higher level of capital for any activity subject to Federal or State regulation than would be required by an applicable regulatory authority for a company engaged in such activity, unless the Corporation shall find that particular circumstances warrant a higher level of capital;

"(iii) any practice or arrangement that may adversely affect the independence or impartiality of an affiliated insured institution in the provision of credit or other services or the terms on which such credit and services are made available, or the availability of such credit; and

"(iv) any material adverse effect on the safety and soundness or financial condition of an affiliated insured institution.

"(E) The Corporation shall by order set forth the reasons for any disapproval under this paragraph. Inaction on any notice or a Corporation order determining not to disapprove a proposal to engage in an activity that has previously been authorized by regulation under this paragraph shall be final and shall not be subject to judicial review under this section or in any other manner: *Provided, however,* That any savings and loan holding company may obtain judicial review pursuant to this section of any Corporation order not to disapprove a notice under this paragraph if such order contains restrictions or conditions.

"(F) The Corporation may by regulation prescribe limitations on the conduct of any activity or activities authorized under subparagraph (2)(F) of this subsection other than limitations on activities conducted pursuant to clause (v) thereof, consistent with the criteria in subparagraph (D) hereof and with safe and sound financial practices.".

SEC. 20. Subsection (d) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(d)) is hereby amended as follows:

(1) The introductory phrase is amended to read as follows: "(d)(1) Except as otherwise provided in this section, no subsidiary insured institution of a savings and loan holding company shall—";

(2) Numbers (1), (2), (3), (4), (5), and (6) shall be redesignated as (A), (B), (C), (D), (E), and (F), respectively, and letters (A), (B), and (C) shall be redesignated as (i), (ii), and (iii); and

(3) The following subsection (d)(2) shall be added at the end thereof: "The prohibitions of subsection (d)(1) shall not apply to the transactions of any subsidiary insured institution of a savings and loan holding company with an affiliate engaged in the business activities specified in subparagraphs (F) and (G) of subsection (c)(2) of this section except for clause (ii) of subparagraph (F); unless the context otherwise requires, such transactions by an insured institution shall be subject to the same limitations and prohibitions specified in sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and d) as if such insured institution were a member bank. The Corporation may prescribe rules or regulations for purposes of defining and clarifying the applicability of the limitations and prohibitions described in the preceding sentence.".

SEC. 21. Subsection (e) of the Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a(e)) is hereby amended by amending clause (ii) of subparagraph (1)(B) to read as follows—

"(ii) acquired in connection with a reorganization in which a person or group of persons exchange their shares of an insured institution for shares of a newly formed holding company and receive, after such reorganization, substantially the same proportional share interest in the holding company as they held in the insured institution, except for changes in shareholder interests resulting from the exercise of dissenting shareholder rights under State law.".

SEC. 22. The Savings and Loan Holding Company Amendments of 1967 (12 U.S.C. 1730a) are hereby amended by deleting subsection (n) thereof, and inserting in lieu thereof the following new subsection (n):

"(n) No State shall prohibit the affiliation of an association, as that term is defined in subsection 1462(d) of this title, with a company engaged solely in one or more of the activities described in subparagraphs (F) and (G) of paragraph (c)(2) of this section.".

AMENDMENTS TO THE HOME OWNERS' LOAN ACT OF 1933

SEC. 23. Section 5(c) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(c)), is amended by amending subparagraph (B) of paragraph (4) to read as follows:

"(B) SERVICE CORPORATIONS.—Investments in any 'depository institution service corporation,' as that term is defined in the Depository Institution Service Corporation Act (12 U.S.C. 1861, et seq.) and in accordance with the requirements, conditions and limitations specified in that Act.".

SEC. 24. Subsection 5(q) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(q)) is amended by adding a new paragraph (6) to read as follows:

"(6) Any action for injunctive relief that may be commenced by any person pursuant to paragraph (2) of this provision, may be commenced on the behalf of such person by any trade association of which such person is a member: *Provided*, That any such action commenced by a trade association shall be subject to the same requirements, limitations and conditions as would be applicable had such action been commenced by any such person pursuant to paragraph (2) of this provision.".

SEC. 25. The Bank Service Corporation Act (12 U.S.C. 1861 et seq.) is hereby amended to read as follows:

"SHORT TITLE AND DEFINITIONS

"SECTION 1. (a) This Act may be cited as the 'Depository Institution Service Corporation Act.'

"(b) For purposes of this Act—

"(1) The term 'appropriate Federal supervisory agency' shall include 'appropriate Federal banking agency' as defined in section 1813(q) of this title (12 U.S.C. 1813(q)) and the Federal Home Loan Bank Board with respect to any 'insured institution' as defined in section 1730a(a)(1)(A) of this title (12 U.S.C. 1730a(a)(1)(A));

"(2) The term 'depository institution service corporation' means a corporation organized to perform services authorized by this Act, all of the capital stock of which is owned by one or more depository institutions;

"(3) the term 'depository institution' means any institution subject to examination and supervision by any 'appropriate Federal supervisory agency';

"(4) The term 'invest' includes any advance of funds to a depository institution service corporation, whether by the purchase of stock, the making of a loan, or otherwise, except a payment for rent earned, goods sold and delivered, or services rendered prior to the making of such payment; and

"(5) The term 'principal investor' means the depository institution that has the largest dollar amount invested in the capital stock of a depository institution service corporation. In any case where two or more depository institutions have equal dollar amounts invested in a depository institution service corporation, the corporation shall, prior to commencing operations, select one of the depository institutions as its principal investor and shall notify the depository institution's appropriate Federal supervisory agency of that choice within five business days of its selection.

"AMOUNT OF INVESTMENT IN DEPOSITORY INSTITUTION SERVICE CORPORATION

"SEC. 2. Notwithstanding any limitation or prohibition otherwise imposed by any provision of law exclusively relating to any depository institution, a depository institution may invest not more than 10 per centum of paid-in and unimpaired capital and unimpaired surplus in depository institution service corporations. No depository institution shall invest more than 5 per centum of its total assets in depository institution service corporations.

"PERMISSIBLE DEPOSITORY INSTITUTION SERVICE CORPORATION ACTIVITIES FOR DEPOSITORY INSTITUTIONS

"SEC. 3. A depository institution may invest in one or more depository institution service corporations that perform, and a depository institution service corporation may perform, the following services only for depository institutions and credit unions: check and deposit sorting and posting; computation and posting of interest and other credits and charges; preparation and mailing of checks, statements, notices, and similar items; credit information, appraising, construction loan inspection, and abstracting; developing and administering personnel benefit programs; research, studies, and surveys; purchasing office supplies, furniture and equipment; developing and operating storage facilities for microfilm or other duplicate records; and clerical, bookkeeping, accounting, statistical, data processing, internal auditing, and similar functions performed for a depository institution.

"SERVICES TO NONSTOCKHOLDERS

"SEC. 4. No depository institution service corporation shall unreasonably discriminate in the provision of any services authorized under this Act to any depository institution that does not own stock in the service corporation on the basis of the fact that the nonstockholding institution is in competition with an institution that owns stock in the depository institution service corporation, except that—

"(1) it shall not be considered unreasonable discrimination for a depository institution service corporation to provide services to a nonstockholding institution only at a price that fully reflects all of the costs of offering those services, including the cost of capital and a reasonable return thereon; and

"(2) a depository institution service corporation may refuse to provide services to a nonstockholding institution if comparable services are available from another source at competitive overall costs, or if the providing of services would be beyond the practical capacity of the service corporation.

"REGULATION AND EXAMINATION OF DEPOSITORY INSTITUTION SERVICE CORPORATIONS

"SEC. 5. (a) A depository institution service corporation shall be subject to examination and regulation by the appropriate Federal supervisory agency of its principal investor to the same extent as its principal investor. The appropriate Federal supervisory agency of the principal shareholder of such a depository institution service corporation may authorize any other Federal supervisory agency that supervises any other shareholder of the depository institution service corporation to make such an examination.

"(b) A depository institution service corporation shall be subject to the provisions of the Financial Institutions Supervisory Act of 1966 as if such service corporation were the same type of depository institution as its principal investor, except that the appropriate Federal supervisory agency of the principal investor shall be authorized to apply such provisions to a depository institution service corporation.

"(c) Notwithstanding subsection (a) of this section, whenever a depository institution that is regularly examined by an appropriate Federal supervisory agency, or any subsidiary or affiliate of such a depository institution that is subject to examination by that agency, causes to be performed for itself, by contract or otherwise, any services authorized under this Act, whether on or off its premises—

"(1) such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the depository institution itself on its own premises, and

"(2) the depository institution shall notify such agency of the existence of the service relationship within thirty days after the making of such service contract or the performance of the service, whichever occurs first.

"(d) The appropriate Federal supervisory agencies are authorized to issue such regulations and orders as may be necessary to enable them to administer and to carry out the purposes of this Act and to prevent evasions thereof.

"GRANDFATHER RIGHTS

"SEC. 6. (a) Notwithstanding any other provision of law—

"(1) any service corporation owned by one or more depository institutions and acquired or maintained and operated pursuant to the Bank Service Corporation Act of 1982 (12 U.S.C. 1861 et seq. (1982, repealed 1983)) or pursuant to subparagraph (B)(4) of section 5(c) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(c)(B)(4)) and any regulations promulgated thereunder, may engage in those activities in which (i) it was lawfully engaged on July 1, 1983, and

(ii) it has been engaged continuously since July 1, 1983; and

"(2) any depository institution that (i) lawfully invested in a service corporation within the meaning of paragraph (1) of this subsection as of July 1, 1983, and (ii) continuously maintained an investment in such a service corporation since July 1, 1983, may maintain and increase such investment, provided that any such investment is made and maintained in accordance with all conditions, requirements, and limitations applicable thereto under the laws described in paragraph (1) of this subsection.

"(b) The authority conferred by subsection (a) of this section shall terminate, with respect to any covered service corporation, at such time as such service corporation expands its activities to include any new activity, or, with respect to any covered depository institution with an investment in such a service corporation, at such time as such depository institution invests in excess of the limitations set forth in subsection (a)(2) of this section in any service corporation: *Provided*, That any appropriate Federal supervisory agency may, upon application by a service corporation or depository institution that would be required to terminate activities of or divest stock ownership in a service corporation, authorize such service corporation or depository institution to maintain its activities or stock interest for an appropriate period of time in the public interest, but in no event shall such time period exceed one year.

"MUTUAL THRIFT SERVICE CORPORATIONS

"SEC. 7. Notwithstanding any other provision of law, any association, which is organized and continues to operate in the mutual form, is authorized to invest in the capital stock, obligations, or other securities of any corporation organized under the laws of the State in which the home office of the mutual organization is located, if the entire capital stock of such corporation is available for purchase only by savings and loan associations of such State and by Federal associations having their home offices in such State, but no mutual organization may make any investment under this section if its aggregate outstanding investment under this section would exceed 3 per centum of the assets of the mutual organization, except that not less than one-half of the investment permitted under this section shall be used primarily for community, inner-city, and community development purposes. This section shall be interpreted under the Home Owners' Loan Act of 1933, and regulations lawfully promulgated thereunder as of July 1, 1983.".

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II

98TH CONGRESS
1ST SESSION

S. 1682

To redefine "bank" for purposes of application of the Bank Holding Company Act of 1956, to equate unitary savings and loan holding company and multiple savings and loan holding company activities, and to apply the provisions of the Glass-Steagall Act equally to insured depository institutions.

IN THE SENATE OF THE UNITED STATES

JULY 26 (legislative day, JULY 25), 1983

Mr. GARN (for himself and Mr. PROXMIRE) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To redefine "bank" for purposes of application of the Bank Holding Company Act of 1956, to equate unitary savings and loan holding company and multiple savings and loan holding company activities, and to apply the provisions of the Glass-Steagall Act equally to insured depository institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Depository Institution Equity Act of 1983".

TITLE I—AMENDMENTS TO THE BANK HOLDING COMPANY ACT

DEFINITION OF BANK

Sec. 101. Section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) is amended to read as follows:

"(c) 'Bank' means (1) an 'insured bank' as that term is defined in section 3(h) of the Federal Deposit Insurance Act, as amended; (2) any institution that is eligible to become an insured bank under section 5 of the Federal Deposit Insurance Act, as amended; or (3) any institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa or the Virgin Islands, that accepts deposits that the depositor may withdraw by check or similar means for payment to third parties and is engaged in the business of making commercial loans. The term 'bank' does not include (A) any foreign bank having an insured branch; (B) an 'insured institution' as that term is defined in section 408(a)(1) of the National Housing Act, as amended; (C) any organization operating under section 25 or section 25(a) of the Federal Reserve Act; or (D) any organization that does not do business in the United States except as an incident to its activities outside the United States.".

BANK HOLDING COMPANY ACTIVITIES OTHER THAN BANKING

SEC. 102. Section 4(a)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(a)(2)) is amended by inserting after ", after December 31, 1980,", the first place it appears, the following: "or, in the case of any company which becomes, as a result of the enactment of the Depository Institution Equity Act of 1983, a bank holding company on the date of such enactment, two years after date of such enactment,".

TITLE II—AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

AFFILIATION OF INSURED NONMEMBER BANKS WITH ORGANIZATIONS DEALING IN SECURITIES

SEC. 201. Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) is amended—

(1) by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively, and by adding the following new paragraph (3):

"(3) The provisions of section 20 of the Banking Act of 1933, as amended, relating to affiliations between member banks and organizations engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities, shall be applicable to every nonmember insured bank in the same manner and to the same extent as if such nonmember insured bank were a member bank: *Provided,* That a nonmember insured bank which prior to the date of enactment of the Depository Institution Equity Act of 1983 was affiliated with such an organization is not prohibited from continuing that affiliation for a period of two years after the date of enactment of such Act. The provisions of this subsection shall not apply to any foreign bank having an insured branch with respect to any affiliation between such bank and any company organized under the laws of a foreign country that is not engaged in business in the United States except as an incident to its activities outside the United States."; and

(2) in the first sentence of paragraph (4)(A), as so redesignated under paragraph (1), by inserting after "or any lawful regulation issued pursuant thereto," the following: "or any provision of section 20 of the Banking Act of 1933, as amended,".

PERSONS EXCLUDED FROM SERVING AS OFFICERS, DIRECTORS, OR EMPLOYEES OF STATE NONMEMBER BANKS

SEC. 202. Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding at the end thereof the following:

"(m)(1) No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or similar securities, shall serve at the same time as an officer, director, or employee of any nonmember insured bank except in limited classes of cases in which the Board of Directors may allow such service by general regulations when in the judgment of the Board it would not unduly influence the investment policies of such bank or the advice it gives its customers regarding investments. The provisions of this subsection shall not apply to any officer, director, or employee of any foreign bank, as defined in section 1(b)(7) of the International Banking Act of 1978, having an insured branch in the United States, but shall apply to officers and employees of the insured branch.

"(2) A person who at the time of the enactment of the Depository Institutions Equity Act of 1983 was serving in a position as an officer, director, or employee of any nonmember insured bank and in a position otherwise prohibited by this subsection is not prohibited from continuing to serve in such positions for a period of two years after the date of enactment of such Act.".

TITLE III—AMENDMENTS TO THE NATIONAL HOUSING ACT

UNITARY SAVINGS AND LOAN HOLDING COMPANY ACTIVITIES

SEC. 301. Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding at the end thereof the following:

"(o) A savings and loan holding company, or any subsidiary thereof which is not an insured institution, shall not commence, after the enactment of the Depository Institution Equity Act of 1983, or continue for more than one hundred and eighty days after becoming a savings and loan holding company or subsidiary thereof, any business activity other than those specified for multiple savings and loan holding companies and their subsidiaries under subsection (c)(2) of this section: *Provided, however,* That, a company existing as a savings and loan holding company on the date of enactment of the Depository Institution Equity Act of 1983, whose business activities or the activities of any subsidiary become subject to the restrictions of subsection (c)(2) as a result of such enactment, may continue such activities for not more than five years after such enactment.".

AFFILIATION WITH ORGANIZATION DEALING IN SECURITIES

SEC. 302. Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding at the end thereof the following:

"(p)(1) The provisions of section 20 of the Banking Act of 1933, as amended, relating to affiliations between banks that are members of the Federal Reserve System and organizations engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities, shall be applicable to every insured institution in the same manner and to the same extent as if such insured institution were a bank that was a member of the Federal Reserve System: *Provided*, That, notwithstanding section 408(o) of this Act, an insured institution which prior to the date of enactment of the Depository Institution Equity Act of 1983 was affiliated with such an organization is not prohibited from continuing that affiliation for a period of two years after the date of enactment of such Act.

"(2) For every violation of this subsection the insured institution involved shall be subject to a penalty not exceeding $1,000 per day each day during which such violation continues. Such penalty may be assessed by the Corporation, in its discretion, and, when so assessed, may be collected by suit or otherwise."

PERSONS EXCLUDED FROM SERVING AS OFFICERS, DIRECTORS, OR EMPLOYEES OF INSURED INSTITUTIONS

SEC. 303. Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding at the end thereof the following:

"(q)(1) No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or similar securities, shall serve at the same time as an officer, director, or employee of any insured institution except in limited classes of cases in which the Corporation may allow such service by general regulations when in the judgment of the Corporation it would not unduly influence the investment policies of such insured institution or the advice it gives its customers regarding investments.

"(2) A person who at the time of the enactment of the Depository Institutions Equity Act of 1983 was serving in a position as an officer, director, or employee of any insured institution and in a position otherwise prohibited by this subsection is not prohibited from continuing to serve in such positions for a period of two years after the date of enactment of such Act.".

INSURED INSTITUTIONS ENGAGING IN SECURITIES BUSINESS

SEC. 304. Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding at the end thereof the following:

"(r) The civil and criminal provisions of section 21 of the Banking Act of 1933, as amended, relating to dealers in securities engaging in banking business, shall be applicable to insured institutions' activities and uninsured institutions' activities in the same manner and to the same extent as if the institutions were banks that engaged in the business of receiving deposits.".

TITLE IV—EFFECTIVE DATE

SEC. 401. This Act shall take effect upon enactment.

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The Chairman. As I've indicated previously, I believe that Congress should deal with all the issues and not just attempt to solve the questions at hand by postponing their resolution. For 50 years our financial system functioned efficiently and safely with little change in our banking statutes. Recently, however, the financial marketplace has changed dramatically. Old certainties have given way to new ambiguities and consumer demands for broader and more sophisticated financial services have spurred financial service providers to offer a broad array of new and convenient services.

Through a variety of methods, competitors have discovered, enlarged and exploited gray areas in the network of banking statutes and regulations to create new competitive opportunities. Creative lawyers working for securities firms and insurance companies have used their talents to free their institutions to meet the needs of the marketplace. But fundamentally, such a situation is not healthy.

These efforts of fine-tuning and end runs are a direct result of Congress typical unwillingness to face and solve the problems in a financial marketplace that has outgrown our banking statutes. Congress reluctance to update the statutes and the industry's aggressiveness in seeking opportunities to offer new services have resulted in an unbalanced and unfair system where some institutions are free to compete while others have their hands tied.

This imbalance provides a disservice to both competitors and consumers. Congress should face the issue, decide what policy is best for our Nation, and then enact that policy.

Today the policy is being decided by the regulatory agencies, the courts, and in the marketplace.

The administration's proposal, which has the support of the Federal Reserve, would have Congress establish a revised Federal statutory framework under which bank and thrift holding companies would operate. It covers issues such as bank municipal bond underwriting authority which has been previously discussed and passed by the Senate.

While supporting some of the bill's provisions, I want to know more about others, but in any event, I wish to congratulate the Secretary and his staff for the effort they have made in developing such a comprehensive proposal. It serves as a foundation for this new round of hearings.

Today we are happy to welcome the Secretary of the Treasury, Donald Regan, to testify before the committee regarding the issues addressed in S. 1609 and S. 1532. I am particularly pleased, Mr. Secretary, that after some rather long negotiations that not only your Department, the Treasury Department, but the Federal Reserve has also agreed to support this latest effort by the administration.

I also want to once again thank you for the continued close cooperation that you and I have had the last 3 years in developing changes in the regulatory structure and in the financial policy of this country to more nearly meet the revolution that is taking place in the marketplace. So we thank you for your willingness to be here this morning and before I turn to you I'd ask Senator Riegle if he has any opening remarks he wishes to make.

Senator Riegle. Mr. Chairman, no. I have a number of questions I want to address to the Secretary. We just got your statement, as you know, so we have not had a chance yet to analyze it fully, but I am interested in hearing from you and I have some questions a little later.

The CHAIRMAN. Senator Hecht, do you wish to make any remarks?

Senator HECHT. No questions. Thank you.

The CHAIRMAN. Senator Proxmire.

STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Mr. Chairman, I welcome the opportunity to discuss with the Secretary the banking deregulation legislation his Department has recommended to the Congress. Although I joined you in introducing this legislation at the request of the administration, there are some provisions in the bill I cannot support. Chief among them is the virtual repeal of the insurance provisions of the Garn-St Germain bill enacted by the Congress less than 1 year ago. This is a 180-degree turn from the position taken by this committee and the Congress last year and I see no evidence that the Congress has changed its mind on this important issue.

There are provisions of the legislation, however, that merit the serious consideration of the committee. I have long supported the ability of banks to underwrite revenue bonds and to offer mutual funds to their customers. I was also pleased to see that the Treasury bill plugs the so-called nonbank bank loophole so that all banks will be subject to the standards contained in the Bank Holding Company Act. The bill also streamlines the procedures for submitting applications under the Bank Holding Company Act that should reduce the regulatory burden on bank holding companies.

Mr. Chairman, as we proceed with these hearings I think it is important to keep in mind the urgent necessity of bringing this legislation to an early markup. The ability of the Congress to shape the structure of our financial services industry is being eroded daily. I would have preferred to have passed the Federal Reserve moratorium legislation first before proceeding to the Treasury bill although I respect your decision to combine them. Nonetheless, the committee needs to give a definitive answer to these questions as soon as possible. We already have had voluminous oversight hearings on these issues and I believe we should be prepared to act soon. Every day we delay could permanently foreclose our future options for dealing with the financial restructuring issue in a fair and rational manner.

The CHAIRMAN. Secretary Regan, please proceed.

STATEMENT OF DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you.

Mr. Chairman and members of this distinguished committee, I appreciate this opportunity to discuss with you the administration's opposition to a legislative moratorium on nonbank banking activities and to suggest as an alternative our proposed legislation, the Financial Institutions Deregulation Act.

In April, at the onset of this committee's hearings on the state of the financial industry, I commented on the "crumbling wall" between the securities and banking industries. Today I would like to expand on that idea by outlining for you a scenario in the non-too-distant future.

SCENARIO IN THE NON-TOO-DISTANT FUTURE

The financial consumer of tomorrow marches up to the local, automated bank teller and requests a broad range of financial services. He may have to step inside to a window. But at one place or the other he would be able to purchase stocks and bonds, insurance and real estate and conduct traditional banking transactions as well.

And if that consumer arrives home forgetting the one household item he set out to buy, he may use his personal computer and order a toaster from the bank's consumer goods subsidiary.

The ideal world of the future? Possibly, but there is one element in this scenario that must be considered—the question of safety. And that's the question this committee has to answer for the American consumer.

I believe the answer can be emphatically "yes" if those of us in Government provide a comprehensive, responsible structure for the future growth of the financial services industry; one that will insure the safety and soundness of our domestic financial system for the years ahead.

IRRATIONAL INCONSISTENCIES IN COMPETING INSTITUTIONS

Our proposal seeks to establish a system which will, first and foremost, benefit the consumers. Second, it deals with the problem of irrational inconsistencies in the current regulatory treatment of substantially similar and competing institutions. Under the pressures of competition, the differences between the regulatory treatment of essentially similar depository institutions can only become wider.

Without action by Congress to bring order out of this chaos, depository institutions and their holding companies will begin a migration to more liberal regulatory environments.

Congress, then, must act promptly, but not by enacting a moratorium on innovation and initiative. Indeed, those who will have to curb their activities because of a moratorium will be commercial banks and thrift institutions. Existing nonbank banks will still be climbing over that proverbial wall to get into banking activities while commercial banks and thrifts are forced to sit idly by.

If you doubt what I am saying is true, then I call your attention to the planned acquisition by American Express of Allegheny Corp.—owners of the "giant" mutual fund company, Investors Diversified Services and MSL Industries, manufacturers of fabricated steel products. Simply stated, American Express, which currently owns a brokerage firm, insurance company, and an international bank, will soon own as well a mutual fund company and a steel producer.

Clearly, deregulation efforts have accelerated in recent months to the extent that concerns have been growing in the Congress and elsewhere about the fragmentation of our financial system and the possible weakening of the system due to too many uncoordinated and sometimes risky approaches to deregulation.

As a result, a moratorium on further deregulation of depository institutions activities by State legislatures and Federal regulatory agencies has been introduced in Congress.

ADMINISTRATION OPPOSES A MORATORIUM

The administration opposes a moratorium because, if adopted, it could remove all pressure for reform and simply be extended from year to year. Meanwhile, firms that already have entered new markets would become more entrenched, making it more difficult for Congress to have any constructive impact on the industry, and making subsequent entry by new firms more difficult when the moratorium is finally lifted.

Therefore, we have introduced our Financial Institutions Deregulation Act at this time so that Congress can act on legislation that will have a positive effect on the financial system by enhancing the competitive benefits for all participants, particularly consumers, and by removing inequities in the current system.

Our proposal—which has been endorsed by the Federal Reserve Board and has received the support of leaders within the financial community—deals with many complex, technical and difficult issues concerning the structure of our Nation's financial system. The debate over the shape of that structure is one that has been underway for many years. This administration proposal represents a balanced approach to arriving at a resolution of this debate. Furthermore, a senior level working group of representatives from the departments which form the Cabinet Council on Economic Affairs will be meeting with the many interested groups in connection with the bill to encourage the addition of improvements which the administration is open to consider.

Throughout the bill's development process, some versions were inadvertently released or leaked to members of the press, Members of Congress, and industry groups. As a result, it's been a little like the seven blind men who were trying to describe an elephant; each had a different impression of what an elephant was because each was only feeling one part. Now that hearings have begun, all interested parties should be able to clearly see the entire "elephant."

The current bill follows, yet enhances the structure of last year's bill, the Bank Holding Company Deregulation Act of 1982. It allows bank holding companies, but not banks or their subsidiaries, to engage in certain new activities. The new bill expands upon that concept to provide parallel treatment of bank and thrift holding companies by establishing the same authorizations and limitations for each of their activities.

I would like to take a moment to explain why we believe that bank and thrift holding companies should be subject to parallel treatment.

Comprehensive reform of the financial services industry and deregulation of depository institutions demands the inclusion of all depository institutions if we are to achieve our goal of competitive equality. Last year's Garn-St Germain Act made thrift powers, which now include limited commercial lending authority, very similar to those of banks. Leaving thrifts out of the bill would create competitive inequality among financial institutions because multiple savings and loan holding companies would not be authorized to engage in the new activities under the bill as bank holding companies would, while unitary savings and loan holding companies would be free to engage in virtually unlimited activities, as is Sears Roebuck, provided they conform to certain requirements of the Internal Revenue Code.

And savings and loan service corporations, would, like unitary savings and loan holding companies, provide the thrift industry a competitive advantage in services without having to reorganize as holding companies.

The resulting inequality would nullify the level playing field that we want to create for all companies offering financial services.

Moreover, including thrifts in the bill should strengthen the thrift industry by attracting additional capital as a result of expanded financial service opportunities. It is true that restrictions on the range of activities of unitary savings and loan holding companies would prevent some additional capital from coming into the industry through acquisitions by outsiders. While this is theoretically possible, there have been very few such acquisitions over the years. Far more important would be the infusion of new capital resulting from the many new multiple savings and loan holding companies that will be created to make use of their expanded powers.

Some critics of the bill contend that it restricts the activities of unitary thrift holding companies. These restrictions, however, serve the purpose of promoting competitive equality among bank and savings and loan holding companies. The working group of the Cabinet Council on Economic Affairs is meeting with those in the financial services industry to answer these and other questions.

EXPANSION OF FINANCIAL SERVICES TO THE PUBLIC

The legislation you have before you would authorize holding companies for all depository institutions—commercial banks and savings and loan associations—to expand the financial services they can offer the public, and thus to compete more effectively with less regulated financial service organizations. Specifically, these expanded activities would include: Dealing in and underwriting municipal revenue bonds; sponsoring and managing investment companies and distributing their securities; insurance underwriting and brokerage; real estate investment, development, and brokerage, subject to a 5-percent capital limitation; owning both a thrift and a bank; all activities currently permitted by law or regulation for bank holding companies and multiple savings and loan holding companies; and activities the Federal Reserve Board, by regulation, determines to be of a financial nature or closely related to banking.

While these expanded activities will go a long way toward ensuring competitive equality among financial institutions, it is consumers who stand to benefit the most from this newly deregulated environment. Indeed, it is consumers who demand such deregulation.

Today's customers are becoming increasingly sophisticated, financially and technologically, and they expect the same of the businesses they patronize.

Witness, for example, the startling success of diversified nonbanking firms such as Sears Roebuck, Merrill Lynch, American Express, and Prudential-Bache, which are rapidly approaching the point where they can offer one-stop financial shopping. Every customer which opens an account at one of these firms is in effect saying to all of us in this room that they prefer the convenience and variety associated with supermarket-style shopping.

This new consumer sophistication was first witnessed on a large scale in the high inflation of the 1970's when depositors abandoned fixed rated accounts at commercial banks and thrift institutions in favor of the market rates paid by money market mutual funds. Since then there has been a proliferation of new financial instruments for consumers—ranging from variations on the once-staid home mortgage to the recently introduced and phenomenally successful money market deposit account. In only 6 months, more than $360 billion has been deposited in these new accounts.

Clearly, consumers are reaping major benefits from financial deregulation and innovation. As more and more firms enter the financial services marketplace and diversify their activities, they will be able to offer consumers a wide variety of financial products at competitively lower prices and greater convenience of selection and service. Consumers will continue to reap these benefits as financial institutions restructure themselves to be more responsive to the changing needs of the marketplace.

The causes of the dramatic changes that are occurring in the industry are well known:

First, The public's increasing financial sophistication and preference for the convenience of one-stop shopping;

Second, improving computer technology;

Third, expanding diversified financial service organizations; and

Fourth, accelerating competitive pressures on banks and other traditional financial intermediaries.

In light of these developments, it is clear that depository institutions and other financial service firms must be able, if they choose, to combine into diversified financial service organizations in order to compete in a radically restructured market. Substantial movement in this direction has occurred already. Indeed, the rate of restructuring seems to increase daily.

COMPETITION WITH SAFETY AND SOUNDNESS

The administration's proposal will enable the Nation's banks and thrifts to compete more effectively in the financial services industry without jeopardizing their safety and soundness, imposing undue burdens on the Federal Government, or creating unfair competitive advantages. It will resolve many of the anomalies and inconsistencies in the current system of regulation, so that similar and competitive institutions are treated alike. And, consumers will benefit from the additional number of firms able to expand the range of products and services available to the public at competitively lower costs.

In closing, Mr. Chairman, I want to emphasize the urgency of the situation confronting this committee and the Congress. The problems resulting from the regulatory inequities in the financial services industry are real and immediate. Obviously, the industry is not willing to wait for Congress to act when market dynamics and competitive pressures leave them no choice. If Congress is going to have any impact on the future structure of this industry, it must act quickly and decisively.

This administration believes the financial system of the future should be legislated by Congress, and not enacted by Federal regulatory action or State initiatives. An economy as complex as ours requires a financial system that is applicable nationwide, but which provides flexibility for other initiatives to keep it sensitive to changing market conditions. And we believe our holding company concept does this.

The entire financial marketplace is changing, and we cannot, indeed should not, halt its pace. Therefore, this is not the time for Congress to enact a moratorium on innovation.

Rather, the administration is looking forward to working with the members of this Committee, the Congress and the financial services industry to insure that a strong, healthy and competitive domestic financial system emerges from this legislative process.

Mr. Chairman, that concludes my testimony. I'll be pleased to answer any questions the committee might have.

[Complete statement follows:]

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.
July 18, 1983

Testimony of the Honorable Donald T. Regan
Secretary of the Treasury
Before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

I appreciate this opportunity to present the Administration's proposal to deregulate the activities of depository institution holding companies.

INTRODUCTION

Last year we introduced a proposal for bank holding company deregulation, in conjunction with a proposal to deregulate the lending and investment powers of thrift institutions. The thrift industry proposals constituted the major elements of the Garn-St Germain Depository Institutions Act of 1982, which the President signed into law in October. However, Congress decided not to deal with bank holding company deregulation at that time. The President, in signing the Garn-St Germain Act, therefore called for prompt action this year to enact the Administration's bank holding company deregulation proposal.

During the first half of 1983 this Committee has held extensive hearings on the need for additional financial system reform. I am pleased, Mr. Chairman, as a part of this process, to reintroduce our holding company legislation, entitled the Financial Institutions Deregulation Act (S. 1609). It differs from last year's proposal in two major respects. The current version provides a comprehensive framework for expanding the financial service powers of thrift institutions as well as commercial banks. In addition, it modifies the supervisory responsibilities of the Federal Reserve Board.

This proposed legislation deals with many complex, technical and difficult issues concerning the structure of the Nation's financial system. The debate over the future structure of our financial system is one that has been underway for many years. This Administration proposal introduces a balanced approach to resolving this debate. We expect an ongoing dialogue with the many interested groups in connection with the bill and the legislative process should bring forth improvements which the Administration is open to consider.

The Administration's proposal will enable the Nation's banks and thrifts to compete more effectively in the financial service industry without jeopardizing their safety and soundness, without imposing undue burdens on the Federal government, and without introducing unfair competitive advantages. Consumers should benefit from the additional number of firms able to expand the range of products and services available to the public at competitively lower costs. The proposal will also resolve many of the anomalies and inconsistencies in the structure of the current system which should strengthen depository institutions.

THE NEED TO REFORM THE FINANCIAL SERVICE INDUSTRY

Recent developments in the financial service industry have all but eliminated most traditional distinctions between banking and nonbanking services. Diversified nonbanking firms such as Sears-Roebuck, Merrill Lynch, Shearson/American Express, and Prudential-Bache are rapidly approaching the point where they can offer one-stop financial shopping. Merrill Lynch has indicated it soon may acquire a savings and loan. Prudential Insurance Corporation has received notice from the Federal Deposit Insurance Corporation that the FDIC has no objection to its acquisition of a commercial bank in Georgia which Prudential will operate as a nonbank bank. Just last week, Shearson/American Express, which already owns a securities firm, a large insurer, an overseas bank, and a major credit card business, announced plans to buy Alleghany Corporation, the parent of Investors Diversified Services, a securities and investment management firm.

The causes of the dramatic changes that are occurring in the financial service industry are well known:

1. The public's increasing financial sophistication and preference for the convenience of one-stop shopping;

2. Improving computer-based technology;

3. Expanding diversified financial service organizations; and

4. Accelerating competitive pressures on banks and other traditional financial intermediaries.

In light of these developments, it is clear that depository institutions and other financial service firms must be able, if they choose, to offer diversified financial service products in order to compete in a radically restructured market. Substantial movement in this direction has occurred already. Indeed, the rate of restructuring seems to increase daily.

We are seeing more and more of these multiproduct financial firms because existing statutes do not prohibit new combinations of firms never before thought to be economical or advantageous. In addition, state legislatures and Federal regulators, unhappy with the slow pace of deregulation by Congress, are taking their own initiatives to advance deregulation of the financial service industry.

* Last year Washington Mutual Savings Bank of Seattle, Washington, acquired a full-service broker-dealer firm; a Federal Reserve member bank cannot do this under the Glass-Steagall Act.

* Stock savings and loan associations have been acquired by Sears-Roebuck, National Steel, and other organizations not closely related to the savings and loan business as is required for banks under the Bank Holding Company Act. Increasingly, savings and loan associations have been converting from mutual to stock form; this will enable them to form holding companies which can enter any line of commerce.

* South Dakota has authorized banks chartered under its laws to engage in all aspects of the insurance business, and other states have adopted similar "reforms" in their banking laws. Federally-chartered banks are not permitted to engage in insurance activities or other nonbanking financial services, and bank holding companies have only very limited insurance powers.

* Nonbank banks, which do not come under the Bank Holding Company Act because they either do not make commercial loans or do not accept demand deposits, have been established or acquired by organizations outside the banking business, and their holding companies are seeking authorization to expand deposit taking activities interstate. To the extent that these banks are not members of the Federal Reserve System, the Glass-Steagall

Act may not apply to the activities of their affiliates, and to the extent that the Bank Holding Company Act is inapplicable to such nonbank banks, the Douglas Amendment to the Bank Holding Company Act may not apply either.

- Two months ago the Federal Deposit Insurance Corporation proposed a regulation that would permit bona fide subsidiaries of insured nonmember banks to engage in all facets of the securities business except certain underwriting activities. The FDIC previously had determined that the Glass-Steagall Act does not prohibit insured nonmember banks and savings banks from engaging in any securities activities, including underwriting and dealing, provided they do so through bona fide subsidiaries. National and state member banks, however, are not permitted to affiliate with any firms engaged principally in underwriting securities.

Under the pressures of competition, these differences in regulatory treatment can only become wider. Without action by Congress to bring order out of this chaos, depository institutions and their holding companies will begin a migration to more liberal regulatory environments. National banks will seek state charters; state-chartered banks will withdraw from Federal Reserve membership; commercial banks will convert to thrift charters; where possible, bank holding companies will become thrift holding companies; and firms will continue to acquire thrifts in an effort to avoid the prohibitions of the Glass-Steagall Act. Ultimately, interests will be put in place that will make comprehensive and balanced reform impossible.

DEREGULATION AND THE CONSUMER

The environment outlined above is very disturbing to many of us. Nevertheless, we must recognize that today's marketplace is responding primarily to the radically enhanced financial sophistication of consumers. Individuals and households, in addition to corporate entities, now are increasingly aware of the gains to be had from even the most rudimentary of efforts at portfolio management.

This "new" consumer sophistication was first witnessed on a large scale in the high inflation of the 1970s when depositors abandoned fixed rate accounts at commercial banks and thrift institutions in favor of the market rates paid by money market mutual funds. Since then there has been a proliferation of new financial instruments targeted at the consumer -- ranging from variations on the once-staid home mortgage to the recently introduced and phenomenally successful money market deposit account.

Clearly, consumers are reaping major benefits from financial deregulation and innovation. For instance, it took investors less than three months to place $300 billion in higher interest money market deposit accounts and super-NOW accounts when they were first authorized, a reaction that surprised everyone. As more and more firms enter the financial services marketplace and diversify their activities, they will be able to offer consumers a wider variety of financial products at competitively lower prices while providing greater convenience of selection and service. Consumers will continue to reap these benefits as financial institutions restructure themselves to be more responsive to consumer needs in the future.

The task before us, therefore, is to provide for a marketplace in which the flexibility of financial institutions and the overall safety and soundness of our financial system can be advanced as compatible, rather than incompatible, goals.

MORATORIUM PROPOSAL

Deregulation efforts have accelerated in recent months to the extent that concern has been growing in the Congress and elsewhere about the fragmentation of our financial system and the possible weakening of the system due to too many uncoordinated and sometimes risky approaches to deregulation.

As a result, the Federal Reserve Board proposed a legislated "stand-alone" moratorium on further deregulation of depository institution activities by state legislatures and Federal regulatory agencies until Congress can undertake a comprehensive review of appropriate financial reform legislation. The moratorium has the support of many members of Congress because it will delay their having to make tough decisions on complicated legislation that divides many interest groups. At Chairman Volcker's request, Senators Garn, Heinz, Proxmire and Dodd have already introduced the Federal Reserve's moratorium bill, S. 1532, as a temporary measure to focus and expedite public discussion. The six-month moratorium would expire on December 31, 1983.

Chairman St Germain of the House Banking Committee has also introduced an even stricter retroactive moratorium that would require divestiture of all cross acquisitions of financial service firms and of all new activities undertaken pursuant to regulatory actions since January 1, 1983. His moratorium has no expiration date so the Congress would not even have to take action to continue it indefinitely.

The Administration opposes a moratorium because, if adopted, it could remove all pressure for reform and likely be extended from year to year. Meanwhile, firms that already have entered new markets would become more entrenched, making it more difficult for Congress to have any constructive impact on the industry, and making subsequent entry by new firms more difficult when the moratorium is finally lifted. Therefore we have introduced our Financial Institutions Deregulation Act at this time so that Congress can act on legislation that will have a positive deregulatory effect on the financial system by maximizing the competitive benefits for all participants, particularly consumers, and by removing distortions in the current scheme of regulation.

The bill is designed to "chill" engagement in new activities after July 1, 1983 by providing that upon its effective date, bank and thrift holding companies would have to conform these new activities to the bill or divest their bank or thrift subsidiaries.

PRINCIPAL FEATURES OF THE PROPOSED LEGISLATION

The current bill follows the conceptual framework of last year's bill (the Bank Holding Company Deregulation Act of 1982) in that it permits banks to engage in certain new activities through holding company affiliates but not directly through the bank or its subsidiaries. The new bill expands upon that concept to provide parallel treatment of bank and thrift holding companies by establishing the same authorizations and limitations for each of their activities.

Scope of the Bank Holding Company Act

The bill broadens the scope of the Bank Holding Company Act to apply to any company that controls a Federally-insured bank, an institution eligible to become a Federally-insured bank, or an institution that both accepts deposits that may be withdrawn on demand and makes commercial loans. This change brings Federally-insured nonbank banks, as well as non-Federally-insured state chartered banks and thrift institutions, under the jurisdiction of the Bank Holding Company Act.

New Activities

The bill would permit bank or thrift holding companies to engage, directly or through holding company subsidiaries, in the following activities:

- -- dealing in and underwriting municipal revenue bonds and some tax-exempt industrial development bonds;
- -- sponsoring and managing investment companies and distributing their securities;
- -- insurance underwriting and brokerage;
- -- real estate investment, development, and brokerage, subject to a 5% capital limitation on real estate investment and development;
- -- activities the Federal Reserve Board determines to be "of a financial nature" or closely related to banking;
- -- owning both a thrift and a bank; and
- -- all activities currently permitted by law or regulation for bank holding companies and multiple savings and loan holding companies.

The bill requires the Federal Reserve Board, within 180 days after the effective date of the act, to promulgate regulations listing and describing specific activities that are of a financial nature and activities that are closely related to banking. In defining activities of a financial nature, the Board is directed to "promote competition between bank holding companies and all other companies engaged in activities of a financial nature or closely related to banking." The Board has the right to prescribe limitations on these activities consistent with stated criteria and with safe and sound financial practices.

In the securities area, certain activities would have to be conducted through a securities subsidiary of the holding company or through the holding company itself, as would all securities brokerage, underwriting, and dealing activities that are now authorized for banks. However, if a bank or thrift holding company or its nondepository institution subsidiary did not engage in the new specified securities activities or discontinued those activities, it could continue to conduct currently authorized securities underwriting or dealing activities within its bank or thrift or their subsidiaries.

IMPORTANCE OF THE HOLDING COMPANY REQUIREMENT

A key element of the bill is the requirement that nonbank and nonthrift activities be performed through a holding company for several reasons.

First, banks and thrifts are unique financial intermediaries affected with a public interest. As such, they are Federally-supervised, have access to a Federal lender of last resort, and have some portion of their deposits Federally-insured. The Administration does not believe that they should *directly* engage in new and risky activities that cannot be regulated effectively by a depository institution regulatory agency. This would place an inappropriate supervisory and insurance burden on the Federal government.

Second, the unique status of depository institutions enables them to raise money in the private financial markets at a lower cost than most other borrowers. The relative safety of funds deposited with the institutions permits them to pay slightly less for the large volumes of money they raise than other firms pay for their borrowings. In addition, demand deposits, which have no explicit interest rate, make up a significant portion of depository institution resources, especially for banks. The institutions should not be able to use the lower cost funds to directly engage in activities with non-depository institution competitors. Nor should they be able to use these funds to capitalize direct subsidiaries at advantageous transfer costs (equity prices) which will give a direct subsidiary capital costs lower than those of independent competitors. This is especially true since independent firms other than the very largest raise most of their short-term funds through some form of borrowing from a depository institution. Inherently this borrowing will be at a mark up over the institution's melded cost of funds.

Although the bill does not directly address tax issues, it will advance the equal tax treatment of all competitors involved in conducting municipal finance activities. Banks currently can deduct 85 percent of interest paid on deposits as an expense of purchasing or carrying tax exempt securities, but nonbank dealers generally are prohibited from deducting interest they pay on debt incurred to buy tax-exempt obligations. By requiring banks to conduct municipal securities activities in holding company affiliates, the bill would place bank and nonbank organizations on the same footing in this respect.

The Administration also does not believe that non-depository institution activities should be conducted through a subsidiary or service corporation in which a bank or thrift has a direct equity investment. The investment would be at risk if the subsidiary's activities were to falter, and the funds for the investment would be raised with Federal assistance not available to non-depository institution competitors and at a cost advantage to the bank or thrift. Notwithstanding this belief, the

Administration bill would authorize mutual thrifts to engage through service corporations in more extensive activities since only equity savings and loans can be owned by holding companies and, thus, mutual savings and loans could not take advantage of the holding company form of organization.

Third, the holding company approach permits equivalent regulation of functionally equivalent activities but without imposing additional or duplicative regulation on these activities. Under our bill, all subsidiaries of bank and thrift holding companies would be subject to regulatory supervision appropriate to the subsidiary's line of business. For example, insurance and real estate activities would continue to be primarily regulated by state agencies. Securities subsidiaries would be regulated as broker-dealers or investment advisers by the Securities and Exchange Commission and state securities regulators, and also may be members of securities industry self-regulatory organizations and the Securities Investor Protection Corporation. By requiring new and existing securities activities to be performed in holding company affiliates, the bill in effect removes securities activities from primary supervision by bank and thrift regulatory agencies, thereby avoiding multiple layers of regulation. Thus, the framework would permit a wide variety of financial organizations with different regulatory regimes to be included under the holding company umbrella in a manner that maximizes competitive equality with independent firms without imposing more regulation on their activities.

Finally, if Congress were to adopt the holding company approach as the underlying principle of depository institution deregulation, many of the inconsistencies and anomalies that currently confuse the issue of bank deregulation would be resolved. National banks, state-chartered member and Federally-insured member banks, stock savings banks, and stock savings and loans would be able to associate themselves through holding companies with a broader range of financial services and thus would have access to a broader spectrum of customers than their limited activities currently permit. Financial service firms would be able to acquire or charter banks and thus, to offer their customers the unique services that banks can provide; controversy over nonbank banks and unequal regulatory treatment of different categories of depository institutions would disappear.

Simplified Holding Company Formation

Currently banks and thrifts that want to reorganize as holding companies must first go through an expensive and time consuming process of obtaining regulatory approval. The bill provides a simplified procedure for organizing a holding company where there is no change in control. In general, the requirement of prior approval of the Federal Reserve Board or the Federal Savings and Loan Insurance Corporation is relaxed in connection with a reorganization in which shareholders of the bank or thrift transfer their shares to a newly formed holding company and receive substantially the same proportional share interest in the holding company. A similar exemption is provided from the registration requirements of the Securities Act of 1933. These provisions are intended to reduce the burdens involved in forming a holding company. They should be of particular help to small institutions that otherwise might be deterred from forming a holding company and taking advantage of the newly authorized activities.

INCLUDING THE THRIFT INDUSTRY

I would like to take a moment now to explain why we believe bank and thrift holding companies should be subject to parallel treatment. Comprehensive reform of the financial service industry and deregulation of depository institutions would be incomplete for several reasons if thrifts were not included. Last year's Garn-St Germain Act made thrift powers, which now include limited commercial lending authority, very similar to those of banks. Leaving thrifts out of the bill would create competitive inequality among financial institutions because multiple savings and loan holding companies would not be authorized to engage in the new activities under the bill as bank holding companies would, while unitary savings and loan holding companies would be free to engage in virtually unlimited activities, as Sears-Roebuck currently is, provided they conformed to certain requirements of the Internal Revenue Code. And savings and loan service corporations, which are unrestricted in the range of services they can offer, would, like unitary savings and loan holding companies, provide the thrift industry a competitive advantage in services and an opportunity to avoid having to reorganize as holding companies. The resulting inequality of treatment would vitiate the level playing field that we want to create for all companies offering financial services.

Although some attention has been given to the fact that our bill restricts the activities of unitary thrift holding companies, these restrictions serve the important purpose of promoting competitive equality among bank and savings and loan holding companies. Furthermore, those who complain about these restrictions have not been able to point to a single activity or service that a unitary thrift holding company should be able to perform that a thrift holding company could not engage in under our proposal.

We also believe that nonbanking activities conducted in service corporation subsidiaries impose undue risks on Federally-insured banks and thrifts and unacceptable burdens on the Federal deposit insurance system. It is just as important for thrifts, as it is for banks, to conduct their nonthrift activities in a holding company in order to be insulated from the risks of non-traditional thrift activities. We think their holding company activities should be limited to those activities specified in the Act at this time in order to give us some experience with the expanded holding company format.

Finally, including thrifts in the bill should strengthen the thrift industry by attracting additional capital as a result of acquisitions by outsiders of the many new savings and loan holding companies that will be created to take advantage of expanded financial service opportunities. Companies seeking to increase their activities will acquire thrift subsidiaries, thereby providing thrifts with a new source of capital. This infusion of new capital should far outweigh any loss of capital that might occur as a result of restricting the range of activities of unitary savings and loan holding companies. Thus, we believe our proposal is in the long term interest of the thrift industry.

I should note, Mr. Chairman, that we certainly recognize that including thrift institutions within the scope of this legislation will be controversial in some quarters. In this regard, we will be working with the thrift industry, the Federal Home Loan Bank Board and other interested parties in the days ahead with a view toward the development of a final legislated package that clearly balances the interests of all concerned.

OTHER FEATURES OF THE LEGISLATION

Restrictions on Inter-affiliate Transactions

While the holding company approach can insulate banks and thrifts from the risks associated with nonbanking activities, it cannot prevent holding companies from misusing their control over depository institutions. To deal with these concerns, our proposal contains provisions that regulate banks' and thrifts' transactions with their holding company affiliates. These provisions are in addition to restrictions previously implemented by the Garn-St Germain Act. The principle underlying these provisions is that transactions between a bank or thrift and its affiliates must be made on substantially the same terms and under substantially the same circumstances, including credit standards, as those prevailing at the time of the transaction for comparable transactions with non-affiliated companies. These limitations are designed to ensure that banks and thrifts will avoid relationships with their affiliates that would threaten the bank's or thrift's soundness or provide affiliates with unfair competitive advantages through favorable financing terms or other devices.

Prior Notice for Bank Holding Company Activities

Under the bill, bank and thrift holding companies may engage in any of the activities by filing a notice with the Federal Reserve Board or Federal Savings and Loan Insurance Corporation, respectively, and furnishing certain information required under the bill. If the agency does not act to disapprove the activity within 60 days of the date the notice is filed, the holding company can commence the activity.

The agency is provided with specific criteria to determine whether to disapprove the proposal. These are (1) any inadequacy in the managerial and financial resources of the holding company, (2) any practice that may affect the impartiality of the subsidiary bank or thrift in allocating credit to customers, and (3) any materially adverse affect on the safety and soundness of the affiliated bank or thrift.

This process and these standards are intended to represent a deregulation from current bank holding company law, which (1) requires bank holding companies to file an application with the Fed to engage in a much more restricted range of activities, (2) does not require the Fed to act within any particular period of time, (3) provides authority for a time-consuming hearing, and (4) authorizes the Fed not to approve any application if it finds that to do so might promote "undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices."

Private Right of Action by Trade Associations

Because of their importance as lenders, banks and thrifts may have the opportunity to condition the extension of credit upon acceptance of other services from their affiliates. The insurance industry, for example, is particularly concerned about the possibility of tie-ins of credit and insurance. Although existing law explicitly prohibits such tie-ins by banks and thrifts or their subsidiaries, and permits injured parties to sue to prevent these practices, certain trade groups argue that enforcement by injured parties alone may not be adequate to deal with the problem. Accordingly, in order to strengthen enforcement of the anti-tie-in laws, the bill provides for a private right of action by a trade association on behalf of a member to obtain an injunction against a bank or thrift that is alleged to be violating the anti-tying provisions of either the Bank Holding Company Act or the Home Owners' Loan Act.

Grandfathering

The bill contains certain grandfather rights for "nonbank bank" holding companies, unitary savings and loan holding companies, and bank and thrift service corporations. Grandfathering provisions permit continued engagement in activities that a company commences prior to a date specified in legislation prohibiting the activity. The purpose of grandfathering is to prevent unfair retroactive application of laws to activities that a company in good faith commenced while the activity was legal. As previously indicated, by using a cut-off date that is prior to enactment or the effective date of the legislation, grandfathering provisions can "chill" engagement after the cut-off date in activities the proposed bill is intended to prohibit.

A company that owned a nonbank bank on July 1, 1983, may continue to operate its nonbank bank provided that the nonbank bank does not both accept demand deposits and make commercial loans. In addition, such a company may continue to conduct those activities in which it was legally engaged on July 1, 1983, and continuously thereafter. Any diversification into new activities or expansion of existing activities authorized for bank holding companies, however, would be subject to all the requirements of the Bank Holding Company Act.

No grandfather rights are provided for any company that acquires a nonbank bank or a thrift institution after July 1, 1983. Therefore, at the effective date of the legislation, such a company must immediately divest its nonbank banks or conform all of its activities to those permissible for holding companies under the Bank Holding Company Act.

Grandfather rights are provided for unitary savings and loan holding companies on the same general basis as for bank holding companies. They may continue to engage in any activities they were legally engaged in on July 1, but may not diversify into new activities or expand their existing activities after that date except in conformity with the bill. No grandfather privileges are provided for any company that acquires an insured institution between July 1, 1983 and the date this legislation becomes effective.

The bill also provides grandfather rights to service corporation investors and for service corporation activities where an investment was made and the activities were commenced by July 1, 1983. This is necessary because in order to conform service corporation activities to the holding company framework, the bill permits banks and thrifts to invest only in depository institution service corporations which are authorized to provide limited services to depository institutions and not to the general public. In addition to maintaining current activities and investments, a service corporation could expand any activities that it was engaged in on the grandfather date and a depository institution investor could expand its investment provided that such expansion conformed with all laws that were in effect on July 1, 1983. The grandfathering authority would terminate with respect to a service corporation at the time it expands into any new activities that were not engaged in on July 1, 1983, or, with respect to an investor depository institution, at the time it invests in a service corporation in a manner not consistent with the laws and regulations applicable to service corporations as of July 1, 1983.

Thrift institutions in mutual form, which comprise 77 percent of all Federally-insured thrift institutions, cannot expand their non-depository activities through a holding company as stock institutions can because mutual thrifts, which are owned by depositors and not shareholders, are unable to use the holding company structure. It therefore is appropriate to permit mutual thrifts to continue to make use of the more expansive service corporation authority available to them before July 1, 1983. Accordingly, the bill authorizes a Federally-chartered mutual thrift to invest up to three percent of its assets in intrastate thrift service corporations subject only to laws and regulations applicable to such service corporations on July 1, 1983. The bill permits mutual thrifts and their service corporations to take advantage of the more expansive current authority with respect to service corporations whether or not the thrift or service corporation existed or engaged in the activities on July 1.

CONCLUSION

Finally, Mr. Chairman, I want to emphasize the urgency of the situation confronting this Committee and the Congress. The problems resulting from the regulatory disparities in the financial service industry are real and immediate. Obviously the industry is not willing to wait for Congress to act when market dynamics and competitive pressures leave them no choice. If Congress plans to have a positive impact on the changing structure of the financial service industry to provide consumers with the benefits of a safe, sound and competitive industry, Congress must act quickly and decisively.

We cannot remove all the anti-competitive barriers at once, but we can begin to approach our objective by putting the proper legal structure in place and by initiating the process of removing as many restrictions as possible. Once the structure is established, the remaining barriers to competition in specific industries and activities can be eliminated at a propitious time.

We hope, Mr. Chairman, that our proposal will have your full support and the support of this Committee. We in the Administration look forward to working with you on this important legislation.

At a later date Congress must also restructure the geographic limitations within which depository institutions may operate, and it must reform the regulatory system to make it consistent with the modernization of depository institution actions. Later this year, when the Vice President's Task Group on Regulation of Financial Services has completed its work, the Administration expects to make recommendations on this latter issue. The legislation we are proposing today does not deal with geographic limitations and is not intended to suggest or endorse any particular outcome to the question of what agency should ultimately regulate bank holding companies.

* * * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

The CHAIRMAN. Thank you, Mr. Secretary.

As I've had the opportunity to review the proposal of the administration the last few days, there are some portions of it I very definitely agree with; others on which I will reserve judgment as we go through the hearing process and listen to different witnesses and certainly work with you on developing them.

I don't see that there is a great deal of difference between the situation that existed 2 years ago when I introduced S. 1720. At that time that proposal was very, very controversial. The initial testimony in October of 1981 indicated that it was even more controversial than I had anticipated. But through working with a lot of different groups we were able to finally come up with a bill that did pass, as you mentioned, and obviously there were many changes in that original piece of legislation.

So I appreciate your pragmatism in recognizing that we are once again starting down that road. There are a lot of differences of opinion on how we should solve this problem and I appreciate your offer of flexibility. I, too, offer that back to you to work with you to see if we can develop some answers to these problems.

MORATORIUM IS NOT THE ANSWER TO THE PROBLEM

The one thing that I totally and completely agree with you and the administration on is that a moratorium is not an answer to the problem. In most of the 9 years that I have been on this committee, we have preferred to delay action, hoping somehow it will go away and the problems would solve themselves. In the early years of my tenure on this committee we had the luxury of more time to do that. The technological revolution that has occurred in the financial services industry, the new innovations that are constantly coming about, do not give us the luxury of that time any more.

It is not that I just oppose a moratorium for the sake of opposing a moratorium. It has been my experience that moratoriums get extended, as you mentioned. The 6-month moratorium would not be devastating at all if at the end of that 6 months we were willing and able to make decisions on many of these issues and come up with legislative language to set a policy.

But I doubt very much, when we look at the timeframe of the 6-month moratorium and looking at our schedule between now and the end of this fiscal year and implementing the 1984 budget, and recognizing that we usually go out of session in December and don't come back in until the end of January and start the legislative and appropriations process all over again, I think the odds of extending that moratorium for at least 90 days, if not another 6 months, are very, very high; as the weather guessers would say, probably about a 95 percent chance that we would do that.

If there were some way to say, OK, Congress will take action during that 6-month period of time, then a moratorium would not be so objectionable. But the issues are not new. They have been around for a long, long time. They have been the subject of at least 4,000 pages of testimony since I have been the chairman of this committee. I think we are in a position where we can make decisions and should, and simply delaying only compounds the problem, in my opinion. It does not solve the problems that we face.

So I hope that we are able to work together. When I say that, I don't mean just you and I. We can very successfully work together. But I mean all of the different groups can recognize that we should come to grips with these problems and also work with the House of Representatives and come up with some changes this year and not delay it through a moratorium until another time. Just passing a bill that says "Stop the world while we decide what we may want to do in the future" certainly does not address the problems.

DEPARTMENT STORES OF FINANCE

In today's Wall Street Journal a front-page article claims that the Treasury bill comes at a time that is somewhat similar to the era of the 1920's because, like today, the financial institutions talk of themselves as department stores of finance, with brokerage as well as banking services, banks sell their own stock to investors and to affiliates just as BankAmerica recently offered its stock to investors without commission fees through its affiliate Charles Schwab & Co. Easy investor credit inflated the stock market of the 1920's. Today, the Fed is considering pulling out of margin regulation, leaving it to the exchanges which might be more easygoing about margin requirements.

Can I have your comments and feelings about the Wall Street Journal this morning—or not about the Wall Street Journal—about their article?

Secretary REGAN. I will restrict myself, Mr. Chairman, if you don't mind, to the article.

As far as the article is concerned, while I was alive in the 1920's, I was still in knickers and I'm not sure I fully agree that today's financial environment is similar to what it was then.

The CHAIRMAN. I can't resist, but I was not alive in the 1920's.

Secretary **Regan**. I was going to say that I doubt that the author of that article was alive either. So we are all guessing here as to what actually did happen, not having been participants in what went on.

But the way I see it, Mr. Chairman, things have changed quite a bit in the 50-odd years since the crash of 1929. I think the world has grown a lot more sophisticated. There's a lot more technology today. There's a lot more regulation today. We have a Federal Reserve System overseeing bank holding companies. We have the Federal Deposit Insurance Corporation. We have more powers for the Securities and Exchange Commission, and things of that nature, to prevent the very things that did go on in the late 1920's.

So I am inclined to think that a lot of those worries are overblown as to whether or not the crash of the 1920's could be repeated. Indeed, the market has fallen more in times since the 1920's than many people would believe, and yet we have never had a repetition of what went on in the 1920's. The banks have gotten themselves into some very perilous situations, yet we haven't had to have a bank holiday as we had in 1932–33.

As a result, Mr. Chairman, I believe that we must proceed with deregulation of financial institutions. In this modern era, customers want it.

If I might take another couple of minutes, I'm reminded of the debate that went on in the 1930's about chainstores. There was quite a debate back in the 1930's as to whether or not chainstores should be permitted. This was particularly true out on the west coast with the advent of the supermarket, which people said would drive the corner grocer out of work and misplace a lot of fine people who had these family businesses, the corner grocery stores.

Well, it turned out, nobody asked the consumer his opinion. Particularly during the era of World War II, the worker and the housewife found it very convenient to go to one store to buy vegetables, to buy meat, as well as drygoods, groceries, and in later years hardware, drugs and the like. Consumers liked this conscience and variety and so they patronized these chainstores. Since the chainstores have made available more products to more consumers at a cheaper price and greater convenience than ever before.

I suspect that the financial services industry is going through much the same thing today, that those who have this great fear of diversified financial service firms, are not looking at the conveniences and the lower costs of these services and the innovations that will take place to the benefit of consumers.

I would rather use the growth of the chainstore as an example than I would the 1920's.

The **Chairman**. Well, the article also argues that side of it, that we do have FDIC and FSLIC insurance and much more efficient securities regulation in the form of the SEC and all that, but one thing that puzzles me a little bit about the article is the administration's proposal hardly goes to the extent of allowing banks to engage in the type of securities activities they were in the 1920's. We've been talking about very limited proposals in money market mutual funds, in municipal revenue bonds and things of that nature.

I would ask the question, if I'm wrong, but I see nothing in your proposal that certainly opens up the world of commerce to the banks and steps across that line of where they are going to own factories and department stores and all of that sort of thing, and the speculative fever in the 1920's was certainly quite different than what the proposals we're talking about today in allowing banks to participate in the securities end of it.

Is that your reading of the administration's bill?

KEEPING A FINE LINE BETWEEN COMMERCE AND BANKING

Secretary REGAN. That's absolutely correct, Mr. Chairman. We do keep that fine line between commerce and banking and we are not in this bill seeking any outright repeal of the Glass-Steagall Act's separation of commercial and investment banking. What we are allowing here is the underwriting of municipal revenue bonds and also mutual funds; but that's as far as we go.

The CHAIRMAN. Well, I believe you would also agree that when Glass-Steagall was written that revenue bonds were virtually nonexistent and banks have always been allowed to write general obligation bonds. In many cases, it has been my experience as a former mayor that some revenue bonds have more security than the full faith and credit of the city. We've certainly seen that in Cleveland and New York where their general obligation bonds certainly were not that safe just because they had the city behind them.

So I have never been able to see the large distinction myself between municipal revenue bonds and general obligation bonds. As a matter of fact, I felt each year as I was putting our bonds out for bid that I would have received a more competitive bid in Salt Lake City had the banks been able to compete in municipal revenue bonds as well.

But I wanted to make the major point that we are not talking about in this bill of expanding into the general area of commerce at all. The proposals are rather limited in comparison to that.

Much has been said during the past few weeks about this proposal. One description is that it is much like Howard Hughes' airplane, the Spruce Goose, that it floats for a while but it can't fly.

General agreement among affected groups may appear far off, but I would like to ask you what do you feel will happen without the adoption of the administration's proposal? Where is the industry and the marketplace going to go if we don't start setting some policy?

Secretary REGAN. It's quite obvious to me, Mr. Chairman, what will happen. Let's take the banks first. I think the banks will go to those States which offer the most advantages to them and allow them into the most other fields of business. South Dakota is a prominent one at this particular moment. I notice that the Governor of Delaware is pushing to have his State follow South Dabota's example. Even New York State is undertaking very serious consideration of additional powers for its banks.

So it's entirely probable that State legislatures will determine the future of the banking system of the United States, absent legislation by the Congress to permit banks to engage in new activities through holding companies.

As far as the thrift industry is concerned, they will go their own merry way, keeping the advantages they have over the banks, expanding into other activities permitted under the Garn-St Germain bill, looking more like banks, and yet not being subject to the same regulation as banks.

The nonbank financial institutions will use all their wits and those of their lawyers to see how close they can come to those powers that the banks already have.

So you will have a hodge-podge of regulation and a hodge-podge of activities. As a result, when the Congress finally gets around to tackling the problem, as indeed it must some day if we are to have a national system, then it's going to be much more difficult to legislate. It's bad enough having to do it in 1983. In 1985 or 1987 it will be worse, in my judgment.

The CHAIRMAN. Many have said that after the enactment of Garn-St Germain we should just stop. Would you agree with me if we were 10 or 12 years behind the marketplace before the passage of the Garn-St Germain bill, that we are still 4 or 5 years behind after, relatively speaking, we have come forward but still have not caught up with the activities that are occurring in the marketplace?

Secretary REGAN. You haven't caught up at all, Mr. Chairman, and there are people out there today—and I don't blame them—this is competitive America and this is exactly what they're supposed to do and what they get paid to do—who are thinking of new ways to expand into other fields.

As a result, you're going to have to run fast just to stay in place, and you're behind at this moment.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

SUPPORT FROM VARIOUS LEADERS IN THE FINANCIAL INDUSTRY

As you were delivering your remarks I was trying to follow them in the printed statement. Your summary and this summary are not the same, and there was one statement I believe I heard you make that I tried unsuccessfully to find in here. Maybe I just wasn't able to locate it, but I thought I heard you say that there was broad support from various financial institutions sectors for this proposal that you put forward today. Did I hear you correctly?

Secretary REGAN. That is correct, you did hear me say that.

Senator RIEGLE. Could you repeat in essence what you said then, or could you find that in your remarks, because I want to just inquire about that.

Secretary REGAN. Surely. I say in my oral testimony which, due to time considerations, is an abbreviated version of the testimony I am submitting for, the record that our proposal, which has been endorsed by the Federal Reserve Board and has received the support of leaders within the financial community, deals with many complex technical and difficult issues, and so on.

Senator RIEGLE. Thank you. Let me just go through some of the sectors as such because I don't know who the financial leaders are that you refer to, but what's been the thrifts reaction so far? Are they onboard here and do the leaders of that industry endorse this?

Secretary REGAN. They are not fully onboard. There is mixed reaction within the thrift industry; 77 percent of federally insured thrifts are not affected by this bill. Those are the mutuals which now are allowed through their service corporations to do many things that are permitted by the Federal Home Loan Bank Board. If they choose to continue in that mode, they are not affected at all by the bill.

The ones who are affected are primarily the unitary thrift holding companies; that is, nonfinancial institution companies that own only one thrift. Their powers will be curbed by this bill.

The large multithrift holding companies will benefit from our proposal and they have mixed emotions about the bill.

Senator RIEGLE. I had gotten the sense that the U.S. League, in a sense representing the industry, was quite concerned about it and had expressed that concern presumably to you, but the Treasury Department, since this proposal has been made.

Secretary REGAN. Yes, they have, and we have gone over the bill with them. We will go over it again with them. But curiously, Senator, we have asked them, "Name one service that you would like to have that you will not be permitted to engage in under this bill," and they have yet to tell us of any.

Senator RIEGLE. What seems to be the focus of their apprehension or their objection to it?

Secretary REGAN. Obviously that question more properly should be addressed to them.

Senator RIEGLE. But I'm wondering what your sense is.

Secretary REGAN. As I understand it, Senator, the main thrust of their objection is, "Look, we've got an advantage now; we've got a lot of things we can do. Why stop us or why try to curb any of us or why bother to include us in the bill? Let us keep the advantage we now have."

Senator RIEGLE. How about the securities industry? Have you heard from them?

Secretary REGAN. I don't think we have heard from the securities industry as a group. We have heard from representatives of individual companies within the securities industry. Their chief concern is, "Will we be allowed to own a thrift institution or a bank under your bill?" And our answer is, "No." And they say, "Why not?" And we say, "Well, we don't think that the Congress is ready to tackle the commercial versus investment banking issue," the same thing that Senator Garn and I were just talking about. We have preserved the distinction here between commercial and investment banking. Were we to wipe out that difference, I think the securities industry would be a lot happier. That is, one part of it, those who want to get into the thrift industry or into the banking business. That part of the securities industry that does not want the banks in any phase of its business obviously likes where we come out; that is, that the banks can't go any further than pure brokerage or underwriting of mutual funds and revenue bonds.

Senator RIEGLE. So is it fair to say that the securities industry, taken as a whole, at the moment is really not onboard in terms of the broad support or endorsement of this package? Is that a fair statement?

Secretary REGAN. I couldn't answer that because I have not seen the results of any poll of the industry.

Senator RIEGLE. Well, are the early signals to the effect that there's strong support?

Secretary REGAN. The securities industry has concerns at this moment. How strong the objection is, I don't know.

Senator RIEGLE. OK. How about the insurance industry? Are they onboard?

Secretary REGAN. The insurance industry, in general, seems to be favorable. Insurance agents as a group are not in favor of this. The ACLI is quite worried about this and we have worked with them. As a matter of fact, they came up with a good proposal the end of last week which we currently are considering in order to prevent some of the tie-ins that they are afraid might exist whereby a bank puts the muscle on some customer to do business with its insurance affiliate rather than through an independent agent.

Senator RIEGLE. What you've said essentially squares with what I have been hearing and reading and sensing, and that is, if you take the thrift industry as a whole, if you take the securities industry as a whole, and if you take the insurance industry as a whole, there is little evidence of broad support. In other words, the leaders that you refer to seem to me to be centered more in the banking industry, and I don't mean to say that they are less important or less vital as the others, but it seems to me that the support has not really been broad across the financial institutions spectrum. "Concerns" is your word, but concerns have been expressed and there does seem to be some opposition out there and maybe we'll need a few more weeks to find out the extent of it. Is that a fair summary?

Secretary REGAN. Yes, I agree with that, and I think this committee definitely should explore all those concerns because as I see it, just as we started down this path 3 years ago, no one bill is going to please all segments of the industry. There's too much at stake here in the way of business that can be gained or lost by individual units within the industry as well as an entire industry. Therefore, you're bound to have these tensions among the industries.

Senator RIEGLE. Right.

Secretary REGAN. Reconciling these points of view is going to be a very delicate task and a very herculean task in some respects, but I think it needs to be done.

Senator RIEGLE. I want to come back in a minute to the condition of the thrifts.

The CHAIRMAN. Could I interrupt, without taking away from your questioning time, just to emphasize what I said earlier? Certainly there is opposition to this bill. I have not sensed the deep emotional opposition that started out with S. 1720. Maybe one of the reasons for that is the fact that they found out before that they could give and take and work together. But the starting positions, yes, there is opposition from people who do not like this proposal; but what I wanted to emphasize is, as the Senator from Michigan very well knows because he was for a few months ranking minority member of this committee during a very crucial time and was intimately involved with me in working out some of the compromises that were necessary to produce a bill; so I just wanted to assure him that the process is no different this time and, yes, we start out with some opposition, and that opposition will have to be mitigated and the process will be such that we will be working, first of all, through the hearings so that everybody's positions can be heard.

Each of the groups that the Secretary has mentioned will be allowed, obviously, to have their day in court and specifically tell us what they like or dislike about the proposal. So we've got a process to go through in trying to work those out.

I would say, however, though, that the most important thing and the real issue is not what each of the industry representatives want, but what is best for the public in setting an overall policy as the end result. But we certainly will be going through that same process in great detail. Everybody will be given their opportunity to extensively tell us what their viewpoint is and what they don't like and see if we can create that general consensus that we did last year.

Mr. Secretary, Senator Riegle was very helpful in that process. He was kind of like thrown in the pool and said "Swim," because it had been going along a lot longer than that and he was brought into the process there, but he was very helpful at the end of that process. So I'm sure he knows what we're talking about trying to put together. And, again, do not take that time away from Senator Riegle's questioning time.

Senator RIEGLE. Well, I thank the chairman for his comment and, as he has said, we did work closely together and I think very constructively, and I expect we can again, hopefully, as we work our way through these issues and others.

But I am concerned here because it seems to me that I detect opposition out there. I detect opposition even within the administration, frankly, and I'm talking about not just within the Reagan administration but within the administrative agencies that deal with financial institutions. I'm told that there was some strong opposition within those agencies to this position and nevertheless this position was arrived at. So that I don't know that we would be fair to ourselves if we were to in any way imply that there's a broad consensus or there's a nice strong feeling that we can just move forward on this basis. I get the sense that there's going to be considerable tugging and hauling here in the very fundamental issues that have not been resolved.

Secretary REGAN. Well, nothing in my statement was meant to imply that. I said that some financial leaders have expressed approval of the bill. I must admit others have not. A lot of the leaders to whom I have spoken personally are not as familiar with the details of the proposal as their Washington representatives. And from the press coverage and their own reading of the bill or descriptions of the bill, they may or may not change their minds as time goes on.

Senator RIEGLE. Isn't it fair to say that this proposal was not markedly different from the last proposal? I mean, there are some differences, but it's not fundamentally different?

Secretary REGAN. I'll try to give you a good example of where we changed it as we went along. By the way, in my prepared testimony I make a reference to the fact there were 101 versions of this bill before it finally emerged, by actual count.

The small institutions, the small thrifts, and the small banks, said, "You're forcing us into the holding company concept. That's very cumbersome, very expensive, and very time consuming." Well, we have worked with the Fed and with the SEC to see what can be done to shorten the reorganization process and to make it not only less onerous but less costly for these institutions. We think we have arrived at a very sensible compromise on this to make it very easy for a small institution wishing to get into these other activities to become a holding company merely by sending a notification form to both the Fed and the SEC if there is no change in ownership.

Senator RIEGLE. I want to come back to the thrifts in my next round, but you serve on the Bush task force.

Secretary REGAN. Yes, I do.

Senator RIEGLE. And we have been waiting for that task force to finish its work and present its recommendations and there was some surprise in some quarters that in advance of that, this proposal comes forward. And I'm just wondering, is this in effect going to be the Bush task force proposal?

Secretary REGAN. No.

Senator RIEGLE. If not, why wouldn't we be better off waiting for that? Why isn't the administration, having set that in motion with you as a participant, following the normal order of things to allow the task force to complete its work.

PURPOSE OF THE BUSH TASK FORCE

Secretary REGAN. Well, let me explain the rationale for that. This bill tries to lay out the powers that will be granted to various financial institutions, particularly banks and thrifts, and what they can or cannot do in the future. The Bush task group of which I'm Vice Chairman, will attempt to determine in a deregulatory way who then will regulate these institutions with these specified powers. If they did not know who was going to be able to do what, it would be very hard to say who should regulate. But once you've set out the powers that the various financial institutions have then you can look at the overall regulation of those institutions. It may be that we can cut back on the regulation. It may be that in view of these powers it will be felt that this is no time to cut back on it. But you couldn't judge that until you knew what they were going to be able to do.

Senator RIEGLE. So are you saying, then, that the Bush task force agrees that this is a division of powers?

Secretary REGAN. Yes.

Senator RIEGLE. So that's been settled within the task force and now the only thing left is who does the regulating?

Secretary REGAN. I was Vice Chairman of it and if anybody is undercutting the Chairman of it I'd like to know about it. But as far as I know, this is the administration's position. It's been fully agreed to at several meetings of the Cabinet Council on Economic

Affairs. It's been before the President of the United States and he's signed off on it.

Senator **Riegle**. I might say I have great admiration for you, as the Vice Chairman, but it's not often that the Vice Chairman gets out in front of the Chairman.

Secretary **Regan**. I think with the Chairman's approval.

Senator **Riegle**. My time is up. I will be back.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Good morning, Mr. Secretary. It's nice to see you again.

I'm going to take a phrase out of your statement, "crumbling wall", and I'm going to add another word to that—"crumbling wall safety." We talk about great philosophical situation in this and let's bring it down to some lowest common denominators.

No. 1, I have a concern about the human element in this. You mentioned about chain stores in the 1930's and 1940's. I really don't see that as a relevant situation because if you have money in your pocket you can go and buy potatos, you can buy a suit of clothes, a pair of shoes anywhere; but when you borrow money, it's an entirely different situation. It takes time to build up credit with banks. People are quite anxious to borrow money whenever they need it and only maybe one-tenth of 1 percent of the people we deal with in Washington are sophisticated enough to know and understand how to go around.

If people are borrowing money, let's just say for a mortgage or something, and the man who grants a mortgage said, "Now we have an insurance company. We want you to buy your insurance from them," and so on and so forth. Please address the human element to me better, would you please? How can you control that?

EXPLOSION IN CONSUMER CREDIT

Secretary **Regan**. First of all, there's been an explosion in consumer credit since approximately the 1960's, particularly through the use of plastic credit cards. We have forms of credit now that never existed early in the 1960's with the advent of the VISA card, MasterCard, American Express card, and the like, and the way that new types of institutions now have these cards available for providing credit to people. So it's not just going to your bank now to borrow. If you wish to borrow to buy something, you can deal with a bank; you can deal with a broker; you can deal with an insurance company; you can deal with a financial nonbank institution in order to borrow money.

In addition, when it comes to mortgages, you no longer have to go to a thrift to get a mortgage. You can go to a bank; you can go to others. I've noticed now that there are many brokerage firms that are offering second mortgages through the use of the brokerage account.

So the whole situation is changing quite a bit. People seem to like this, to be able not to have to go to one place and deal with only one institution. They like to see competition and, if the rates are too high one place, to be able go elsewhere.

An example right now is the automotive companies. Banks choose not to lend money for automobile loans because of their rates. Their rates are up to 14, 15, 16 percent. The automotive companies cut that below 11 percent and are dealing directly through their own finance companies in issuing credit to these people. Customers like it. They like those rates. They are dealing with them more than they are with banks.

So what we're saying is, there's been this proliferation of credit to the advantage of the consumer, and that's what we're trying, in this bill, to promote and preserve.

Senator HECHT. I have to ask you this question, too, I've asked several people appearing before us. How do you feel about the insurance on FDIC insurance? Do you feel that we should 100 percent insure savings accounts?

Secretary REGAN. Up to $100,000, yes. I do not think that you have to go beyond $100,000. I'll tell you why. If a person has more than $100,000 to put into some type of savings account in any institution, that's a fairly sophisticated person. That person can either break up the money and put it into several institutions or, if he chooses to put that amount into one institution, certainly he should be sophisticated enough to follow that institution very carefully if he has that much money in it.

What we are trying to do in our bill is to protect insured deposits and the Federal insurance funds from failures by the banks or thrifts in ancillary activities. For example, if a real estate activity in a holding company goes broke, that has no effect on the insured deposits within the bank or the thrift. On the other hand, if the real estate venture or the insurance venture or what have you were in the bank or thrift itself, it might spill over and affect the Federal deposit insurance funds.

Senator HECHT. OK. That was my next question on regulatory. Now we have a bank—let's just say we have a bank. They are into the insurance, into the real estate, into the development. Who is going to go in and regulate this to make sure the bank keeps the same reserve requirements?

Secretary REGAN. Well, the bank itself will still be regulated by the Federal Reserve, by the Comptroller of the Currency. The thrift will be regulated by the Federal Home Loan Bank Board. And both of them, banks and thrifts, by the FDIC or the FSLIC.

None of this will change under the bill. If a new venture is started and it's started in the holding company, as our bill proposes, then if that venture is in the securities business it would be overseen by the SEC. If it's in the insurance business, by a State regulator. There is no national regulator in that area. And in real estate, again, by local regulation rather than by national regulation.

Senator HECHT. What States have regulations on real estate?

Secretary REGAN. As you know, Senator, States regulate the type of development that would be permitted, for example whether or not you can build a building in a certain location, zoning laws and things of that nature.

Our bill also provides that a bank or thrift holding company no more than 5 percent of its capital in real estate invesment and development activities.

Senator HECHT. No more than 5 percent? I wasn't aware of that. Let's take back in time the Chase REIT a few years ago and many people say that if Chase Bank had not had their name on it that would have gone under. If we would have allowed a lot of banks the past few years when they had this terrible real estate drop, when interest rates went up, would that have affected the financial stability of many banks, in your opinion?

Secretary REGAN. It possibly could have because if they had similar names and the holding company was trying to protect the REIT, the holding company would have to draw on the earnings of one that was profitable to support the unprofitable one. That's not a novel situation in a holding company now where an unprofitable venture is supported by a sister company that is profitable. I don't think that the situation would be any worse in a future decline in realty values than it was, let's say, with the REIT's 10 years ago or, more recently, with our experience in 1981 and 1982 with the thrift industry.

FOREIGN BANKS COMING INTO AMERICA

Senator HECHT. We have a new phenomenon in America the past few years, foreign banks coming into America. Who will regulate these banks if we allow them to engage in these practices?

Secretary REGAN. A domestic bank doing business in the United States and, owned by a foreign parent would be subject to the same regulation by the Fed, the Comptroller, and what have you as far as their banking and bank holding company activities are concerned. If they choose to get into insurance in the United States, their insurance activities would be regulated by State insurance commissioners.

Senator HECHT. You don't see a problem with the foreign intrusion?

Secretary REGAN. Not any more than currently, because right now there is nothing that would prevent their having a bank in the United States, a subsidiary bank in the United States, and an insurance company in their home country.

Senator HECHT. Have the State regulators commented on this particular type of legislation to you?

Secretary REGAN. I have not personally talked to any States about this. Let me see if any of my staff has.

[Witness consulting with his staff.]

Secretary REGAN. We have not yet talked to any States. As we've said, we stand willing to talk to them if they wish to talk to us about it.

Senator HECHT. There's an old adage, "If the wheel isn't broken, why fix it?" Our banking requirements and reserve requirements have held this country very well as far as protecting the public's money since the days of the depression. Just because, let's say, Sears Roebuck is going out into another field, why do we have to react? They have been selling All State insurance. Many years ago their merchandising policies were not the best and they fell behind. Why do we here in Washington have to react to this?

Why do we have to fix a wheel that maybe isn't even broken?

Secretary REGAN. For the reason that many companies are getting into banking or near-banking. Let's suppose we don't have this type of legislation. There is nothing that will prevent the Airframe

Co. from buying a thrift and accepting deposits and then turning around and the next day buying an investment firm and being able, as Sears can now, to underwrite corporate stocks and also take deposits. Theoretically, the Congress said that was prohibited 50 years ago, but through unitary savings and loan holding companies, it can be done now.

If that's what the Congress wants, not to have a line drawn between commerce and banking, so be it. But what we are suggesting is that the Congress should legislate in this area in order to prevent this from happening.

Senator HECHT. Thank you. My time has expired.

The CHAIRMAN. Senator Gorton.

DISTINCTION OF UNDERWRITING MUNICIPAL REVENUE BONDS AND CORPORATE SECURITIES

Senator GORTON. Mr. Secretary, your proposal would permit bank holding companies to underwrite municipal revenue bonds but not corporate securities. Why do you have that distinction?

Secretary REGAN. Municipal revenue bonds are very closely allied with general obligations. They are the same type of security except that the source of the income in one is merely the revenues that are taken in from the enterprise and in the other it's a general obligation of a community. Whether one is stronger than the other depends upon the type of moneys that are allocated under the revenue account or what is the true worth of the full faith and credit of the particular city, county or school district. There are some school districts that have gone broke. There are some cities that have gone broke and still sold revenue bonds.

Senator GORTON. Well, is the distinction from the point of view of your legislative recommendation due to the fact that the separate subsidiaries scheme does not offer enough protection in your view to allow even a separate subsidiary to underwrite corporate securities?

Secretary REGAN. No; what we are saying is that these new activities should be carried on in an affiliate that is not too closely allied with the deposit-taking institution protected by Federal deposit insurance. If anything happens to the securities affiliate of the bank or the thrift, we want that to be insulated from the deposit insurance.

Senator GORTON. Well, I think you missed the thrust of my question. Do you feel that that insulation is sufficient, that it is close to perfect? And if you do feel it's sufficient insulation, why isn't your proposal broad enough to allow such an insulated subsidiary to underwrite corporate securities?

Secretary REGAN. The amount of knowledge of a bank as far as underwriting corporate securities is much less than it would be in underwriting revenue bonds because the same people who currently underwrite general obligations obviously would know how to underwrite a revenue bond and judge credit worthiness of the issues and so on.

Corporate securities are entirely different and you seldom find a good municipal underwriter who is also a good corporate underwriter. Therefore, we are saying that these are enough powers for the banks at this time. We suspect that in the future Congress will revisit this issue.

Senator **Gorton**. I see. Let me follow on to a closely allied question then. What's your opinion of the FDIC's proposal to permit State chartered nonmember banks to underwrite corporate securities?

Secretary **Regan**. Well, I think that's biting off a little too much at this particular moment. Our bill would not affect the FDIC's proposal. Nevertheless, I think the FDIC is going a little too fast. We want to go fast, but not that fast.

Senator **Gorton**. Next, in an allied area, I take it that it's your belief that State and local governments favor allowing banks to underwrite municipal revenue bonds.

Secretary **Regan**. Yes, they do.

Senator **Gorton**. Basically because they think they will benefit from lower bank costs?

Secretary **Regan**. From more competition and therefore generally lower rates.

Senator **Gorton**. To what extent are lower bank costs the result of the advantage which banks have in the tax treatment of interest expenses?

Secretary **Regan**. Well, you see many of these issues that they would be underwriting are to be sold to their customers, not to be held in the bank's portfolio. I don't know how much of the issue of the revenue bond a bank would actually be holding in its own portfolio and therefore getting the advantage of the tax treatment.

Senator **Gorton**. Well, under your proposal, of course, the separate underwriting subsidiary wouldn't have that advantage.

Secretary **Regan**. That's true.

Senator **Gorton**. But would there still be cost savings that would be passed on?

Secretary **Regan**. Yes, because of the lower borrowing rate, as far as the individual bank is concerned. I thought your reference was to the State or municipality issuing these bonds. From the point of view of the bank itself, since the bank can borrow money more cheaply due to Federal deposit insurance and also deduct some of the interest it pays on deposits, it would have a lower cost of funds than a regular municipal underwriting house which has to go into the public market or to a bank to borrow. So we want these transactions between the bank and a subsidiary to be at arm's length.

Senator **Gorton**. If they are at arm's length, if because the subsidiary under your proposal does not have that favorable tax advantage, are there still going to be cost savings to be passed on to the State and local customers?

Secretary **Regan**. To the extent that you might have three or four syndicates bidding instead of just one or two syndicates, yes.

Senator **Gorton**. More competition?

Secretary **Regan**. More competition.

Senator **Gorton**. In other words, really the focal point of this is better price structure.

Secretary **Regan**. Yes.

Senator **Gorton**. Section 15 of your proposal prohibits banks from purchasing as fiduciaries any securities from an affiliate with a number of exceptions and from purchasing as fiduciary or principal securities for which the affiliate is a principal underwriter. Why is the prohibition not a total one? In particular, doesn't arm's length suggest that banks and principals shouldn't buy securities from any issue in which the affiliate participates as an underwriter and not simply those in which the affiliate was a principal underwriter?

Secretary REGAN. Let me check that out. I want to look at that specific part of the language.

[Witness consulting with his staff.]

Secretary REGAN. We have a situation existing where, let's say, an insurance company owns an underwriter now of revenue bonds. That insurance company could buy those municipal bonds from its own affiliate.

What we are permitting here is that if a majority of the board of directors of the bank approve of the bank buying the revenue bonds from its affiliate, they will be allowed to do it. We are putting the burden on the board of directors to know what they are doing.

Senator GORTON. I think I understand what you're doing, but is the reason for this simply the equal playing field theory?

Secretary REGAN. Yes, and also to prevent conflicts of interest.

Senator GORTON. OK. Your proposal would also permit purchases by the bank as a fiduciary "if authorized by the instrument creating the relationship," according to the analysis which you provided to us. What circumstances do you have in mind in that connection?

Secretary REGAN. You've got me on the technicalities on that one.

The CHAIRMAN. If you get an attorney asking questions, you have to have an attorney answering them.

Secretary REGAN. I found that out to the cost of my pocketbook sometimes. [Laughter.]

What we're trying to do there is that if a fiduciary wishes to give permission to the bank for the bank to sell it securities in the trust that the bank has underwritten, the fiduciary may allow that to happen.

Senator GORTON. But you would expect that to be an independent decision of the fiduciary.

Secretary REGAN. An independent decision of the fiduciary, so there would be no stuffing by the bank.

Senator GORTON. OK. Your proposal would also permit purchases by the bank as a fiduciary "if authorized by the laws of the jurisdiction under which the trust is administered," and there are a lot of those jurisdictions.

In coming up with that proposal, did you examine the trust laws of all of the 50 States or did you simply make that decision on the basis that this should be a State law decision?

Secretary REGAN. I didn't make the decision. Lawyers did. I suspect they did not look at all 50, but let me check it.

[Witness consulting with his staff.]

Secretary REGAN. They did not look at all 50. They looked at the provisions of those States that have more of the trusts.

Senator GORTON. And so you felt that they were sufficient under those circumstances. This simply is not a decision that this should be a State law decision no matter how strong or how weak those State laws?

Secretary REGAN. No, definitely not.

UNDERWRITING PROFITS

Senator GORTON. Can you, both as Secretary and because of your background, give the committee an overview of the magnitude of underwriting industry profits in recent years and indicate how much of this comes from underwriting general obligation municipal bonds and how much from revenue bonds, and how much from corporate securities; and then compare those to bank profits?

Secretary REGAN. From memory, I can't; but I would be more than willing to submit that for the record, Senator. My judgment would be that we would have to go back and analyze it. At least in one firm I was connected with, I'm not sure we kept a distinction between the two. We looked more to departmental revenues rather than breaking it down by issue. But I would be glad to check to see if that's possible.

[Information subsequently submitted for the record follows:]

RESPONSE TO QUESTIONS OF SENATOR GORTON

QUESTION

How did securities industry profits from underwriting revenue bonds compare with total commercial bank profits during 1981-1982?

ANSWER

The following charts indicate that total profits of commercial banks are much larger than underwriting profits of securities firms. Total underwriting profits of broker-dealers engaged in carrying or clearing activities represented about 13 percent of total pretax commercial bank profits in 1982. Assuming that the percentage of total offering volume for each type of security listed in Chart A approximates the security's proportionate contribution to total profits, revenue bond underwriting in 1982 accounted for $995 million of total underwriting profits, or about 5.2 percent of total bank profits.

A 1979 study conducted by the SEC's Directorate of Economic and Policy Analysis indicates that in 1978 commercial banks underwrote 27.2 percent of the dollar volume of all revenue bonds that were eligible for bank underwriting and 40.7 percent of GOs. [SEC, Directorate of Economic and Policy Research, "Bank Participation in Municipal Revenue Bond Underwriting: Impact on Securities Industry Revenues" 5 (Oct. 19, 1979)].

A. Securities Offerings and Underwriting Profits of Carrying/Clearing Securities Firms */ 1981-1982

(Millions of Dollars)

	1981		1982	
	Dollars	% of Total	Dollars	% of Total
Corporate Debt Offerings	37,793	34	29,392	21
Corporate Equity Offerings	25,976	23	36,237	25
Municipal Offerings				
General Obligation	12,400	11	20,879	15
Revenue Bonds	35,300	32	56,415	39
Total Offerings	111,469	100	142,923	100
Underwriting Profits **/	1,717		2,550	
Number of Firms	1,234		1,253	

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*/ Figures were not available for all securities firms doing a public business.

**/ Underwriting profits are revenues from underwriting adjusted for any direct expenses which can be ascribed to a specific underwriting and for unrealized losses on unsold securities. Indirect expenses, such as employee costs and other related expenses, are not deducted. A breakdown of underwriting profits by type of security was not available.

Source: SEC

B. Profits of Insured Commercial Banks, 1981-1982

(Millions of Dollars)

	1981	1982
Operating Income, Total	247,932	257,188
Operating Expenses, Total	227,714	238,016
Income before Taxes and Securities Gains or Losses	20,149	19,172
Applicable Income Taxes	4,611	3,639
Net Securities Gains or Losses (-) after Taxes	-861	-661
Extraordinary Charges (-) or Credits after Taxes	54	68
Net Income	14,731	14,940
Number of Banks	14,400	14,121

Source: Federal Reserve Bulletin (July, 1983)

Senator **Gorton**. Nevertheless, it is true, without having you check it out, that bank profits are much larger than underwriting profits?

Secretary **Regan**. As a total, yes, but by institution, I'm not sure, because some underwriters in Wall Street are very profitable organizations. Some banks are not.

Senator **Gorton**. I'll come back on the second round. Thank you, Mr. Chairman.

The **Chairman**. Senator Trible.

Senator **Trible**. Thank you, Mr. Chairman.

Mr. Secretary, my own preliminary view coincides with your own assessment of the moratorium question. I agree that a moratorium would inhibit efforts to create a new legislative framework for the financial services industry.

It seems to me that without the steady drumbeat of market innovation ringing in our ears, that Congress simply will not act in a timely fashion.

Moreover, consumers are benefitted from enhanced competition and I would hate to discourage that.

Let me direct your attention to the question of danger or abuse. With the exception of the South Dakota situation, which I find troublesome, no convincing case has been made that existing activities which mix banking and commerce are dangerous or abusive, at least in my judgment. A number of witnesses here, including Comptroller Conover and former Bank Board Chairman Pratt, have indicated they see no real danger in allowing the acquisition of nonbanks or thrifts by nonbanking firms. What is your own assessment of that danger or abuse question?

Secretary **Regan**. My own experience has been based upon observation that those who have spent a lifetime in commerce do not know the subtleties of the banking or thrift business. Those who have been in finance for their careers and have been brought up in finance do understand it.

What our bill is proposing to do is to allow financial institutions to engage in the many fields of finance but to keep nonfinancial people out of those businesses. Taken to the absurd, if there were no separation of banking and commerce, you could go back to the Japanese trading companies where the bank dominated a whole list of industrial companies and, conversely, you could have insurance companies doing the same thing for the benefit of their portfolios and the like.

I'm not sure that that is what the intent of the Congress is at this time. I know from my own point of view that that's not my intention. I can see holding companies of financial institutions doing many things, but I cannot see nonfinancial corporations doing the same thing.

Senator **Trible**. Restricting your response to events that have occurred to date, do you see the potential for abuse or danger?

Secretary **Regan**. Not as yet, no.

Senator **Trible**. Moving on but following this line of questioning, the Treasury bill does not directly address the South Dakota law. What are your own thoughts about how the Congress should respond to that situation? Does it demand a response? And if so, how would you frame that response?

Secretary REGAN. Well, I think it's quite obvious what is going to happen if the Congress doesn't respond. I think that other States will want to compete with South Dakota and will, through their own State legislatures, loosen their own laws to accommodate who should own banks and who should own thrifts and what banks or thrifts should be allowed to do. The net result, in my judgment, will be chaos.

I would prefer to see the Congress rule in this area since this will cross State lines and it will be out-of-State organizations going into a State strictly for the purpose of gaining additional powers. You can't blame them for that. That is what they are designed to do, to maximize profits, and if they can maximize profits by being located in one State rather than the other, they certainly should do that. But rather than have competition among the States for the least regulation, I would rather have the Congress set the limits.

Now the bill we have proposed would not prevent States from authorizing additional activities for banks that are not part of a holding company. However, we are giving a lot of powers to institutions. We think that these are sufficient for this time and that we should gain experience with the amount of powers that they will be exercising and then see later in the day, a year, 2 years, 5 years from now, what whould happen.

Senator TRIBLE. Let me move to a somewhat different area. The Treasury proposal allows banks to affiliate with securities firms indirectly through a subsidiary of a holding company. In what ways do these situations, these bank securities affiliates, differ from the affiliates of the 1920's and 1930's which led to the Glass-Steagall Act?

Secretary REGAN. At the current moment, the affiliates are restricted to strictly brokerage and no underwriting except for general obligations. The proposals in our bill would allow the securities affiliate to go two steps further, the first step being the underwriting of revenue bonds; the second step being the underwriting of mutual funds. But we don't see any great danger in those activities to the banks or the thrifts and we think that these expanded powers are something that their customers really would like them to have.

Senator TRIBLE. And that would then be a different situation from the situation that existed in the 1920's and 1930's?

Secretary REGAN. In the 1920's and 1930's, the banks underwrote all kinds of corporate securities. As a matter of fact, they were the lead underwriters, particularly for their main clients. And they engaged in other than arm's length transactions. If they couldn't sell an issue, they would put the securities in their own trust accounts. That type of thing we're trying to prevent in our bill.

Senator TRIBLE. Thank you, Mr. Secretary.

Thank you, Mr. Chairman. Mr. Chairman, I have some more specific questions, but I would just like to submit those for the record.

The CHAIRMAN. Thank you, Senator.

Senator Mattingly.

Senator MATTINGLY. Mr. Secretary, to sort of continue with the discussion of the Glass-Steagall Act, we're all aware of the abuses that existed in the financial arena during the 1930's that prompted the passage of the Glass-Steagall Act. Would the Treasury proposal safeguard against the recurrence of any of those abuses?

Secretary REGAN. Very definitely, Senator. First of all, our proposal does not allow the banks to underwrite corporate securities. I know of very few cases where underwriting municipal bonds in the 1920's led to any abuses, but there were many obvious abuses in the underwriting of corporate stock.

POSSIBLE ABUSES IN NEW INSURANCE ACTIVITIES

Senator MATTINGLY. A lot of people in the insurance industry are concerned that to allow banks to engage in any new insurance activities will result in a lot of abuses. Do you think that's a legitimate concern?

Secretary REGAN. Yes; I think that is a concern. As a matter of fact, we discussed that with the ACLI. This bill permits individual insurance agents or their trade associations to go into court to seek injunctions if they detect any abuses in this area, and the penalties are rather stiff. So that if they have reason to believe that there are tie-ins with any bank, the insurance agents and their trade associations can certainly stop it.

Senator MATTINGLY. I think there's a great concern by anybody who's in a modest sized insurance business that they're going to be done away with, and I think there's a great danger.

Secretary REGAN. Well, I don't think that necessarily is true. If an insurance agent now is performing good services for people, is handling the situation well, I don't think a person is just going to change because a local bank is now offering insurance brokerage. The danger, of course, would be if the bank said "on condition of a loan" or "we won't do this for you unless you do that," but that's strictly the tie-in type of sale which is prohibited by law and against which an injunction can be obtained.

Senator MATTINGLY. The Federal laws prohibit the tie-in issue now?

Secretary REGAN. That's right.

Senator MATTINGLY. Do you think this legislation is going to prevent possible abuses for banks wanting to expand their insurance activities?

Secretary REGAN. It depends on just how much competition the local bank will be when it sets up through a holding company an insurance affiliate. Many of these activities are pie-in-the-sky that a bank thinks it can do but late will find out that it's inefficient or ineffective in doing and that the local insurance agents can run rings around it.

Senator MATTINGLY. I think it's a legitimate concern by people in the country that small business is going to be at a competitive disadvantages.

Secretary REGAN. I would doubt that this would be true because, first of all, it depends on the type of insurance that the bank is selling. It would depend on the knowledge of the people who are selling the insurance.

Senator MATTINGLY. Haven't the business trends laws lately been more toward encouraging people to leave their small businesses and sell out to larger ones?

Secretary REGAN. No. There are more small businesses being started up each year than are small businesses going out of business. We are very encouraged by the number of new small businesses that are formed every year, particularly in 1982 and 1983.

Senator RIEGLE. Would the Senator yield at that point?

Senator MATTINGLY. Yes.

Senator RIEGLE. I'm just wondering if that's true in the financial services industry. Would you extend that statement to include the areas of financial activity that we are talking about here, that there are more new business starts rather than this consolidation and absorbing that Senator Mattingly speaks about?

Secretary REGAN. That's the impression that I have, but I have no facts specifically in mind at the moment. I'll be glad to answer that for the record.

Senator RIEGLE. I thank the Senator for yielding.

The CHAIRMAN. Let me just interject that in California in 1982 there were more new small financial institution requests than in any year in history, and this year it's running at the rate of about 20 new requests a month, and that's just California.

Senator RIEGLE. If the Chairman would yield, I'm wondering if we've got any data from California or any other place of those that are being absorbed and consolidated and disappearing? Because what you want is a net, it seems to me, and I don't know what the answer is, but I think the Senator from Georgia is asking a good question.

Secretary REGAN. Is the Senator referring to all financial services, insurance, securities brokerage——

Senator RIEGLE. I'm talking about the principal ones. It would be good to start with banking and then move on from there, because it would seem that the other side of the coin of the consolidation that you spoke about with the American Express and the Sears examples and others is that there is a consolidation going on that I suspect is taking its toll down at the far end at the small business level, and I think it's a legitimate question and we ought to have some data on it.

The CHAIRMAN. Well, the data is easily obtainable.

Secretary REGAN. Would that also include the number of employed?

Senator RIEGLE. That would also be interesting to have.

Secretary REGAN. Employed by brokerage firms these days as a result of the activity in the stock market?

The CHAIRMAN. We would ask you, Mr. Secretary, to get whatever information you can and we can have our own staff generate that because through the reports of the State banking commissions and all of the Federal agencies that information is available. We know exactly or can determine how many institutions have been merged and how many new starts there are. So we'll make certain we have that in the record.

Senator MATTINGLY. Thank you.

RISKS INVOLVED IN UNDERWRITING MUNICIPAL REVENUE BONDS

Would you elaborate on the degree of risk involved in allowing banks to underwrite municipal revenue bonds through a separate subsidiary of the holding company?

Secretary **Regan**. I don't think that it's any more dangerous for a bank through a holding company to underwrite revenue bonds than it is general obligation bonds. There are good revenue bonds. There are some that are not so good. There are good general obligation bonds and some that are very poor. I think this is a question of the underwriter taking a very careful look at the type of merchandise he's being asked to bid on or to underwrite and then determining its value.

I think the same thing holds true for buyers, to take a good look at what they are buying. There are rating agencies for this purpose.

So from the point of view of the institution itself, I don't think it's being put in any more jeopardy in underwriting revenue bonds than it is in underwriting general obligations. And take the two worst examples, the current one in the WPPSS situation, the Washington Public Power Supply System versus New York City a couple years ago. They were equally fraught with danger for the underwriters. Luckily, there were no banks in the WPPSS situation now, but there certainly were banks up to the hilt in the general obligations of New York City.

So I don't think the fact that they're one type or another is the distinguishing characteristic. I think it's the underlying credit of the issuer that's important.

Senator **Mattingly**. Do you think this is going to be easier to pass than the IMF legislation?

Secretary **Regan**. I think it will take a little longer to resolve some of the differences here.

Senator **Mattingly**. Thank you.

Secretary **Regan**. The reason I was careful in my answer, we still have to pass the IMF in the House this week.

Senator **Mattingly**. I've been reading about that. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Mr. Secretary, securities firms derive a fair portion of their income from nonunderwriting activities. The 1,000 largest securities firms derived 14 percent of their revenues in 1981 from interest on margin accounts. The SEC in a 1982 staff report said, "the dependency of the securities industry on interest income is a key to understanding its profitability and structure."

What's your view of this? Is it profitable? Is it necessary for securities firms to diversify?

Secretary **Regan**. Mr. Chairman, I've fought this one for over 10 years as the chief executive officer of a large securities firm.

The **Chairman**. That's why I knew you were qualified to answer.

Secretary **Regan**. And I have always denied that it was strictly the interest because money is fungible. You can say that's the sole reason for the profitability of the industry, but certainly if you didn't have brokerage in the first place you wouldn't have margin accounts. So you have to look at how much the firm is making on brokerage and the like.

INTEREST INCOME VERY PROFITABLE FOR SECURITIES FIRMS

Notwithstanding all that, I do agree with you that the interest income of securities firms is very profitable for them. They have an average of about 1 to 1½ percent markup over their cost of money and indeed that at times has represented a very good source of income for them.

The CHAIRMAN. Isn't that basically making loans?

Secretary REGAN. Certainly it's making loans. The margin loan is no different than any other loan and that's why I keep coming back to the fact that everybody is getting into everybody else's business and we need to sort these matters out by some regulation or deregulation.

The CHAIRMAN. Well, I agree. It gets back to the same basic question we have faced now for several years and we talked about let's keep the banking industry just the same. If we do that, it seems to me you've got to put a lot of prohibitions on these other activities, whichever way you go, whether by reregulation or deregulation.

The administration's proposal affects the powers of State-chartered institutions. I suspect there will be some concern about that as you get into the State banking commissions and regulators and their activities. What message do you think this proposal has for the dual banking system?

Secretary REGAN. Well, it preserves the dual banking system insofar as it allows States to determine the activities of State chartered banks that are not part of a holding company. We would not want to do away with the dual banking system.

I'll tell you why. The State banking system has been a great innovator. The NOW accounts came out of the State banking systems. Much of the EFT, electronic funds transfer, has come out of the State banking systems. We don't think that the only new things come from the national system or national regulators. We think the States should be applauded for their efforts and we do not want to do away with the dual banking system.

The CHAIRMAN. In 1963 the D.C. Circuit Court of Appeals overturned a Comptroller's ruling permitting national banks to underwrite revenue bonds. The court concluded that the Comptroller's interpretation of the Glass-Steagall Act and the National Bank Act was simply too broad. The court conceded, however, that revenue bonds were a novel form of financing in the early 1930's, but concluded that Congress had intended to limit bank underwriting activities to securities with unquestioned financial integrity.

Can anyone really assure us that general obligation bonds have unquestioned financial integrity? Are we dealing with a more accurate description that bonds that will provide minimal risk? In other words, what I'm getting at is this case is constantly made and here's a judge 20 years ago who said "unquestioned financial integrity." I don't think too many bonds would have been issued in either category on that strict a standard. So aren't we looking for minimal risk?

Secretary REGAN. Oh, I definitely think minimal risks. Obviously, that decision was handed down prior to what happened in the 1970's to many of our cities, large cities in particular, and as a result, I think the court probably went a little too far in its choice of adverbs.

The CHAIRMAN. We have discussed this several times with different colleagues, but could you assess as specifically as you can what you feel relative underwriting risks are between GO bonds and revenue bonds.

Secretary REGAN. Again, I come back to my answer to Senator Mattingly. There are good GO's and there are good revenue bonds, and there are poor ones in each category also. I think that the underwriting risk of a revenue bond depends upon the issuer and the type of facility that the revenue bond is designed to finance. Many of these revenue bonds are fine bonds and have come and gone and are paid off and have done well.

The CHAIRMAN. You would agree in some cases, then, that certain revenue bonds could be much stronger and much more secure than some general obligation bonds?

Secretary REGAN. Definitely.

The CHAIRMAN. Activities such as insurance underwriting, brokerage real estate development and brokerage, and securities underwriting and brokerage are very diverse, each requiring different expertise, different levels of capital, and so on. What types of bank holding companies will use such powers? Only those with billions of dollars of assets? Do you anticipate the smaller organizations getting into these types of activities as well and, if not, what types of activities would you expect the smaller institutions to get involved in?

Secretary REGAN. Well, I could well see the smaller bank and thrift definitely wanting to get into real estate brokerage and real estate investment and development, up to 5 percent of their holding company's capital because they know the local community and they want to participate in the local community and many of its development phases. Again, whether or not they would want to get into the insurance business would depend upon competition from existing insurance agencies in the area and whether these firms are supplying all the needs of the community. The same thing would be true with brokerage, banks would provide securities brokerage services for their customers who would desire these services because they are not being serviced now by some other organization.

The CHAIRMAN. Does the power to conduct real estate development activities include the power to own a construction company?

Secretary REGAN. At the current moment we are not sure, but the bill provides that the Federal Reserve shall determine those services of a financial nature that a bank or thrift holding company could engage in.

The CHAIRMAN. You want to leave that up totally to the Fed or do you think that when we talk about real estate development activities that we should more carefully define what real estate development activities are?

That's the reason I asked the specific question about a construction company, not that I'm that interested in that particular thing, but just to make a point of what a real estate development activity means.

Secretary **Regan**. I would caution the Congress not to try to get into too much nitty-gritty because if you start down that road I'm not sure exactly where you would end. The Fed has experience in this area. I think it's designed as a regulator to be able to cope with these problems a lot better than the Congress acting under the pressures of enacting legislation and deciding what they would prohibit and what they would allow. I would think that, at least in my judgment, Congress should state a few obvious prohibitions, and then loose words for the Fed to interpret.

IMPACT OF BOILERPLATE LANGUAGE

The **Chairman**. Well, I have some problem with that in general because too often we have used boilerplate language and I remember in many instances where we put in the type of language we gave the Federal Reserve 180 days to come up with rules and regulations implementing this section of the act, simply because we did not want to come to grips with the specifics.

Then when the Fed come up with their regulations, we hold hearings, we bring them before us and condemn them for the silly regulations they came up with. We gave them a blank check. They filled it in and we didn't like the way they filled it in.

Plus, you now have the added problem of the Supreme Court on a legislative veto on which I think you will find Congress is going to have to be more specific rather than allowing the bureaucracy to determine what direction we should be going.

So I don't know exactly where that middle ground is. I have always favored Congress being more specific and leaving less to the interpretation of the regulators. I have also seen a sentence in the law come back in 180 pages of regulations interpreting about 27 words. Literally, there is one example I could give you.

Secretary **Regan**. Probably the IRS.

The **Chairman**. I don't want to take the time, but there were 27 words in an act that resulted in 180 pages of interpretation of those 27 words. I realize that's very profitable for the attorneys involved and a great academic exercise for them. We have seen a great deal of that and I think we are going to have to be more specific in some of these areas if we're going to get a bill through. I think we are going to have to define what real estate investment development is, maybe not every nitty-gritty, but in other areas, because we are in a different situation now with the court interpretations on the power of this Congress.

I certainly want to be more specific, so that people understand what we have passed when we pass it, and not leave so much of it to interpretation, and that has been enhanced by the Supreme Court decision.

From a political standpoint, a lot of these questions, if they are left open, leave opposition that could be mitigated if they understood what some of those terms meant.

So as we work on this and hold hearings, I think in some areas we are going to have to be much more specific in what our intent is and not leave it up to report language and courts deciding what our legislative intent was.

Secretary **Regan**. A word of perhaps advice along those general lines, Mr. Chairman. What we are trying to do here is to allow these institutions to get into anything that's financial but not commercial. I think if you can draw that distinction, I would see banks and thrifts participating in the financial end of real estate development. But the actual commercial part of it, the actual construction and the like, would not be something that banks would be involved in.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Senator Gorton was asking before about your proposal to the effect that a securities affiliate of a bank would be allowed into the revenue bond business, but not really allowed into the corporate security underwriting business. You sort of hung the argument on the notion that technical expertise and history had been involved with general obligation bonds and that those now in the business know this business and so forth.

But the way people move around these days, hiring specialists, even merging with companies that are in that business and pulling them in and setting them up as a subsidiary full-blown, with maybe 10, 20, or 30 years of experience, it seems to me that you really can't say, "Look, you either are not competent or couldn't be competent to get into the securities underwriting business on the corporate side." I think clearly if the door were open and banks wanted into the business they could do so quite readily, and the merger route is one way to sort of do it as a fait accompli.

I got the sense from your answer that you sort of see this securities approach as a two-stage thing. In other words, you take the step now on revenue bonds and in due course history will probably move us on over the next line into the corporate securities underwriting. Isn't that a fair summary?

Secretary **Regan**. Yes; that is in the back of my mind as to the proper way to go, because you have to turn the coin over. As you allow banks to get into the securities underwriting business—that is, corporate underwriting—you will also have to consider allowing investment banking firms into commercial banking in order to keep a level playing field.

You couldn't very well say that a bank could own an investment banking firm and not say an investment banking firm could own a bank. We're not prepared at this moment to permit corporate underwriting. Obviously, if that's the wish of the Congress, we would be more than willing to discuss it with you. But at this particular time we stopped just short of doing that.

Senator **Riegle**. But it is fair to say, then, in your mind at least, that's the logical extension to the next step of this set of rules?

Secretary **Regan**. Yes; in due course.

Senator **Riegle**. Now with respect to revenue bonds as well, you were saying that if the banks got into this business that we would have a more competitive environment and that there was presumably virtue in that, and ultimate gain to the consumer.

Is the reverse of that true today, that you've got a competitive insufficiency in the revenue bond business with the banks being out of it?

Secretary **Regan**. That would depend upon your point of view. I think in the minds of most of the municipalities that we have talked to and Governors of States, they would like to see the banks get into revenue bond underwriting because they think that that would result in lower rates of interest to them.

From the point of view of the current underwriters of revenue bonds, they think they have enough competition at the moment.

Senator **Riegle**. But I'm curious as to what you think.

Secretary **Regan**. I back my own bill.

Senator **Riegle**. But just on the issue of whether there is a current insufficiency of competition in the revenue bond area——

COMPETITION COULD BRING INTEREST RATES OF REVENUE BONDS DOWN

Secretary **Regan**. There is plenty of competition, but there's always room for more.

Senator **Riegle**. Well, I'm sure that's true. Is there room for more in the sense we can plausibly expect that rates would be beaten down? Is that really the logical judgment that we should draw, that we are seeing some kind of interest rate premium today because of insufficient competition that we would see disappear if the banks got into this game?

Secretary **Regan**. Without being able to quantify it, I think in general I would agree that if banks underwrite revenue bonds, that the chances are that rates of interest on revenue bonds would be lower than what they would be if the banks weren't underwriting them.

Senator **Riegle**. And the net of any special tax advantages that would accrue here—in other words, if we equalize the tax treatment on both sides, you still think there would be a lowering of interest rates for revenue bonds if we had the banks in the act, that they could actually find a way to do this for less or pull down the cost here?

Secretary **Regan**. Yes, particularly if, as may well happen in revenue bonds, instead of being negotiated, they become competitive in the way that they are sold.

Senator **Riegle**. I was mentioning other industry sectors that would seem to have some apprehension about this package and I mentioned the S&L's and the insurance industry. I gather the real estate industry and brokers too are expressing some nervousness about this package and I didn't mean to omit them in terms of the list I went through before.

With respect to the S&L's today, is it your feeling that the S&L's are really out of the woods and with the legislation we passed last year that we no longer have to worry about them, or would you share the concern that some have that the S&L's are still in a very weakened state and we have just been witnessing an uptake in interest rates that's beginning to affect them again in a more adverse way, say, rather than 4 or 5 months ago? I'm just wondering if you have a concern at the moment about the thrifts, or are you, by and large, of a feeling that it's clear sailing ahead and the worst is behind them?

Secretary **Regan**. Well, I don't want to appear to be too gilding about the future of the S&L industry. I think they have had a rough time the last couple of years. They are emerging this year and are in a much healthier state today than they were a year ago.

I think at the end of this year they will be in a much healthier state than they are currently because their earnings will continue for the rest of the year.

You've got to remember that the legislation that we're asking for here will probably be passed late this year and be effective in 1984, and by the time the industry gets geared up and starts conducting these new activities we're well into 1984, if not almost into 1985. At that point I think the thrift industry will be in excellent shape to compete with the banking industry or other industries.

Senator **Riegle**. I hope you're right. I'm not quite as optimistic from my vantage point and I guess time will tell.

The Treasury Department has indicated a view over time that they view the S&L's, the thrift industry, and the commercial banks, as being very similar and competitive. In a sense, the tone is that they sort of are able to square off pretty much on an even footing.

SOME COMPETITIVE UNBALANCE

Could you assess for me the degree to which they really are an equivalently competitive situation, particularly in light of the fact that there are some very discreet and clear percentage limitations that we placed upon the thrifts? In other words, we restricted their activities a good deal more than we have the banks and I'm just wondering if you really see them on more or less equal footing today in terms of how they might fare in a direct competitive situation.

Secretary **Regan**. If you compare a small mutual S&L in a small town to one of the major New York banks, obviously there's an imbalance. You have to compare like situations—a small bank versus a small thrift; one of the large California-style thrifts versus one of the large California banks—to see the extent to which they are competitors?

What we did with Garn-St Germain was permit thrifts to do many things that banks can do.

For example, they could put 100 percent of their assets into commercial paper. They could put 40 percent into commercial real estate lending. They could put 30 percent into what's called dealer floor planning. That is, an automobile dealer. They could loan him up to 30 percent of their assets for the automobiles that are on his floor for sale. They can put 10 percent into straight commercial loans, unsecured. Now that certainly makes them look like a bank and act like a bank.

Senator **Riegle**. But you wouldn't call it a level playing field with a bank yet; would you?

Secretary **Regan**. On the other hand, take the small bank that would be doing the same thing. A small bank is into mortgages, very heavily in the mortgage business. A small bank is very heavily into personal consumer loans, as is the thrift.

Senator **Riegle**. But are they boxed with the same limitations that you just described with the thrifts?

Secretary **Regan**. In general, yes. The thrifts still have a few more limitations on these activities, but then, the thrift is allowed a service corporation that can put up to 3 percent of the thrift's assets in many other areas of business and these service corporation activities have been very profitable for them. I don't know—15 or 20 percent of thrifts' earnings come from these service corporation, which is an advantage the banks don't have.

Senator RIEGLE. Yes; but doesn't your proposal affect that in the future here for the Federal thrifts?

Secretary REGAN. No; unless the thrifts decide they want to get into these other things, this legislation does not affect their existing activities. If they are a mutual S&L and they want to continue the way that they have, this legislation does not affect them at all. That's 77 percent of the industry.

Senator RIEGLE. My time is up but I just wanted to make one comment to finish this line of discussion, and that is, it seems to me the thrifts carry another specialized responsibility, and that's mortgage lending, a critical requirement in the country, and we have seen the importance of the housing sector to the national economic recovery and we certainly are seeing that at the present time, and we are also beginning to see the uptake in interest rates beginning to cut into the housing recovery and it has me concerned and I'm sure it's beginning to be a matter of some concern to you.

I think it's important we always bear in mind that this is a very vital national function which we support in other ways, with tax writeoffs and so forth, and it seems to me that any discussion of equivalency or strength or comparative advantage ought to include a recognition of the fact that that housing mortgage function is really a vital national requirement, a national service, and I don't want to see it impaired more than its been impaired. I think its been impaired too much today so it's hard for people even to get mortgages at rates they can afford.

I would hope that we would always be able to keep that as a centerpiece fact in these discussions, so that as we end up sort of trying to balance off competing institutions that we don't take and put too great a burden on the thrifts comparatively, especially now when they are in a weakened state, when they have some enormously important national functions to carry out for us.

Secretary REGAN. Senator, I agree with you, but the industry itself is a little bit ambivalent about this because they're saying, on the one hand, don't take away anything that we now can do, but on the other hand, don't let anybody else do what we can't do. In other words, "Give us more powers if you're going to give someone else more powers, but don't take away what we have now."

Senator RIEGLE. But the starting point has to be who has any differential advantage at the beginning. In other words, I don't know that you're prepared to make the argument that the thrifts have some package of differential advantages that somehow give them great strength and dwarf the powers of the banks in the alternative. I don't think you're prepared to do that.

Secretary REGAN. I don't think they dwarf the power of the banks, but they certainly are permitted to do more things through their service corporations than banks are now. Yes; I would make that argument.

Senator RIEGLE. So would you say, on balance, that the S&L's are generally in better position and have more strength, more latitude, more financial sufficiency today and potential than do the banks?

Secretary **Regan**. More latitude. I'm not sure about more strength.

Senator **Riegle**. But that's the point. If the latitude doesn't convert to a bottom line dollars and cents difference, I'm not sure what the latitude means.

Secretary **Regan**. One of the arguments that the thrift industry makes to us for not making them form holding companies is that they want to preserve the service corporation which is so profitable to them. They can't have it both ways. If these ancillary powers are profitable to them, certainly the latitude must be greater than that of banks.

Senator **Riegle**. Well, I just hope we don't find ourselves in a situation where we have even less mortgage lending capacity, because if that happens——

Secretary **Regan**. I agree with that. That's one thing we are definitely in agreement on.

Senator **Riegle**. Because the country is going to be hot on your trail, as well as ours, if that happens.

Secretary **Regan**. We don't believe that this bill would do that, result in less mortgage lending. If it did, we wouldn't be proposing it.

The **Chairman**. Senator Gorton.

BANK SUBSIDIARIES LIMITED IN REAL ESTATE DEVELOPMENT

Senator **Gorton**. Mr. Secretary, the bill which the administration has proposed authorizes bank subsidiaries to go into real estate development but limits the extent of the capital of the overall entity which can be earmarked for that purpose.

Why do you have that limitation in connection with real estate development but not with other activities?

Secretary **Regan**. Experience in the early 1970's with the REIT's and in 1981 and 1982 with other real estate development, particularly in the thrift industry, indicates to us that real estate development is a risky activity. We have not had experience with this—that is, allowing the bank holding companies and the thrift holding companies to get into this area to any extent.

So we decided that it's best to be a little cautious and put a limitation on the extent of their engagement. This is 5 percent of their capital. Now that can be leveraged, as you know, and 5 percent of their capital leveraged would mean a considerable amount of real estate investment and development could be done by these institutions.

Senator **Gorton**. Mr. Secretary, I'm not at this point being critical or saying that I disagree by any means, but I guess I have the same fundamental question that I asked in connection with securities, the distinctions between corporate and municipal securities, and that comes to the fundamental question of whether or not separate subsidiaries provide sufficient protection for the soundness of the bank itself or not.

It would seem to me logical—now you may want more experience in this respect and I would be perfectly willing to accept that as an answer—but it would seem to me to be logical to say that if there is sufficient protection by reason of the separate subsidiary doctrine, there need not be any limitation on real estate development investment, for example; but if there is not sufficient protection by that separate subsidiary, then it's highly questionable that a bank holding company should be allowed to go into this business at all. Could you comment on this?

Secretary **Regan**. Again, this is judgmental, I must admit, but we have been looking at a bank holding company in Oregon having problems right now. But according to everything that we've been able to find out from the regulators, the bank itself is insulated from the problems that are in the holding company and the fact that the holding company may have to go out of business or go through some type of bankruptcy will have no effect on the bank itself.

That's the type of thing we are trying to do. We haven't seen many losses being taken by organizations that are currently in underwriting revenue bonds. We have seen a lot of losses by real estate development companies and, as a result, we say that prudence suggests that we start out this way, gain experience, and then see where we go from there.

RISK-RATING DEPOSIT INSURANCE

Senator **Gorton**. Thank you. The administration bill would result obviously in some bank holding companies being riskier than others in connection with what activities they made. What do you think of risk-rating deposit insurance?

Secretary **Regan**. That's a fascinating subject. As one who used to be head of an organization that paid for insurance to a national insurance corporation in the securities industry, I've always thought it should be risk related and there should be varying amounts paid by an institution for the various risks that the board of directors wishes to take.

I think, myself, that the idea has a lot of good features.

Senator **Gorton**. What's your opinion of combining the two Federal deposit insurance agencies into a single entity?

Secretary **Regan**. I'll pass on that one. That's one of the things the Bush——

Senator **Gorton**. You're going to leave that for the Vice President?

Secretary **Regan**. That's one of the things the Bush task group is coming up with and I haven't heard from the rest of my members.

Senator **Gorton**. Finally, under the Bank Holding Company Act, the banks can engage in any activities permitted by the State in which they are chartered. We have already talked around the South Dakota situation here in which it passed a law which allows banks to enter into the insurance business but only outside of South Dakota.

Does the administration proposal in any respect address this problem? Should it address this problem? Is this something that is being left to the Bush Commission? What are your views on this subject?

Secretary **Regan**. You mean on State regulation or on the specific power?

Senator **Gorton**. On specific powers, bootstrapped by State law?

Secretary **Regan**. What we are saying is if Congress acts here, then the banks will know exactly what they can or cannot do through bank holding companies, and the pressure for competition among State legislatures will ease. I don't think the States should in this area be granted this amount of permissiveness. I'll tell you why.

We have a national banking system here. We have been debating that. I think the earliest Secretary of the Treasury, Alexander Hamilton, started this debate about who should regulate the banks, the States or the Federal Government. We have a fairly good interpretation of that at this particular moment, but if the Congress doesn't act at this juncture the States themselves will get back into the business of regulating banks, and their answer is going to be to allow them to do practically anything they want to do. So, I fear that more than I fear national legislation.

Senator **Gorton**. If we pass your bill, will South Dakota be out of business in this connection?

Secretary **Regan**. The bill preempts State restrictions on affiliation between national banks and companies engaged in activities authorized by the bill. Banks chartered in the State of South Dakota will not be affected.

Senator **Gorton**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Gorton.

Mr. Secretary, Senator Mattingly had to leave but asked if you would submit for the record an analysis of the current Federal law and prohibitions of the Treasury proposal which attempt to prohibit tie-ins when banks engage in insurance activities.

Secretary **Regan**. Did he specify just insurance?

The **Chairman**. Yes.

Secretary **Regan**. All right.

The **Chairman**. We will have quite a few additional questions for your response in writing. I will have some additional ones and I would expect other Senators, both majority and minority, would as well.

I do appreciate your testimony today and being able to work with you on this issue. I look forward to having a markup this fall and hopefully we will be able to produce some legislation before the year is over and I can't help in ending this hearing to comment that I thought it was impossible for Treasury to go through 101 versions of their bill, which is more than the Fed went through on their moratorium.

Secretary **Regan**. Well, Senator, in concluding, I would like to thank you for your courtesies today and to tell you that we do stand ready to work with you and other groups regarding this legislation. If it can be improved, we are all for that.

The **Chairman**. Thank you very much.

The committee is adjourned.

[Whereupon, at 12 noon, the hearing was adjourned.]

[Response to written questions to Secretary Regan follows:]

Answers to Questions Submitted by Chairman Garn

QUESTION 1

S. 1609 redefines "bank" in order to close the existing "loophole" in the law. This is done by including within the definition "an insured bank" or "any institution eligible to become an insured bank." By including any institution that is eligible for insurance, industrial banks for the first time will become subject to the Bank Holding Company Act.

a. Why, in your opinion, is a revised definition of the term "bank" needed under the Bank Holding Company Act?

b. Why is it necessary to include those that merely are eligible for insurance within the definition of "bank," whether or not they actually have federal insurance?

c. What kind of a new loophole would be created if the Bank Holding Company Act covered only those that actually possessed federal insurance?

ANSWER to 1 (a)

We believe our revised definition of the term "bank" is necessary to further the Bank Holding Company Act's purposes and to create consistency in the treatment of companies that control depository institutions holding Federal or state bank and bank-like charters. The Bank Holding Company Act applies to any company that controls a "bank". The term "bank" currently is defined in that Act to mean any institution that accepts demand deposits and engages in the business of making commercial loans.

The language itself that is used to define "bank" has caused numerous problems because new developments in assets and liabilities of financial institutions have made it difficult to determine what liabilities should be considered demand deposits and what constitutes the activity of commercial lending. For example, controversies currently center on whether NOW accounts or time deposits that do not in fact require notice for withdrawal are demand deposits. With respect to the activity of commercial lending, there are questions regarding the number of commercial loans that must be made to constitute an "activity" and whether a bank is no longer engaging in a commercial lending activity if it sells its commercial loan portfolio to an affiliate. Even if the meanings of these terms were clearly defined, there would continue to be a major problem with the current definition because of its two-part test. Since this definition requires a determination that an entity both accept demand deposits and engage in the business of making commercial loans in order to be a "bank", a holding company can avoid the

Act's coverage if its depository institution subsidiary does not engage in both of these activities. An example of such an institution is a nonbank bank, which generally is an institution that accepts demand deposits but makes only noncommercial loans. Such institutions can obtain Federal insurance for their deposits and still not qualify as banks under the Bank Holding Company Act. Other examples are industrial banks and state-chartered thrifts that engage in deposit-taking and lending activities, but restrict such activities so as not to pass the two-part test under the Bank Holding Company Act definition of "bank".

The current definition of "bank" enables financial service firms that otherwise could not meet the Act's restrictions on nonbanking activities to establish or acquire insured banks and combine the services of these institutions with other financial services not permitted to bank holding companies. This inequality of treatment creates the problem of giving nonbank bank holding companies a competitive advantage over bank holding companies in attracting and retaining financial service customers.

To remedy these problems, Section 7 of our bill would broaden the subjective definition of bank with respect to the deposit test and would also include an objective definition of any FDIC-insured institution or any institution eligible for FDIC insurance. This expanded definition would permit an objective determination as to what is a "bank" and would also permit a subjective decision to be made where FDIC-insurance was not involved but the institution in question operated as a bank.

ANSWER to 1(b) and (c)

The proposed definition of bank is very expansive in including not only FDIC-insured banks, but those eligible for such insurance as well as institutions that meet the expanded two-part test. We believe that the definition should include all FDIC-insured banks as an absolute minimum because of the direct Federal interest in protecting such institutions. As stated in our section-by-section analysis of the bill, it may well be that all legitimate policy objectives for the Federal Government can be met by covering only Federally-insured banks. However, the more expansive definition may be necessary to achieve such objectives as maintaining competitive equality, protecting consumers and community economies, and maintaining public confidence in the system of financial institutions. We believe further discussion of this issue is appropriate.

QUESTION 2

S. 1609 would expand the powers of bank and savings and loan holding companies to include any activities that the Board has determined to be of a financial nature. The section-by-section analysis that accompanied the bill indicated that it is the Administration's intent that the Federal Reserve Board will define these activities in such a manner as to enable such companies "to offer a broader range of services."

a. What additional activities of a financial nature over and above those specifically enumerated in the legislation do you think the Federal Reserve Board should authorize for such holding companies?

b. Would such activities include data processing and, if so, within what sorts of parameters?

c. In what ways does the proposal increase or decrease the powers permissible for unitary and multiple savings and loan holding companies and for savings and loan service corporations?

d. What is your justification for permitting the exercise of expanded powers through a holding company itself -- rather than in a separate subsidiary?

ANSWER to 2(a)

The activities of a financial nature, over and above those specified in the legislation, that the Administration would like holding companies to be able to enter will depend on future developments in the financial services industry. The bill, by giving the Federal Reserve Board the authority to determine appropriate new activities, provides the industry with the flexibility to be competitive with nonregulated financial institutions. The "financial nature" standard of the bill is much broader than "closely related to banking and a proper incident thereto" under current law. Several banks have applied for permission to engage in the financial futures market and others have found that discount brokerage is a service they want to provide to their customers. These activities were not of interest to holding companies until very recently. As holding companies seek permission to offer other financial services that are developed by the marketplace, the Federal Reserve Board, under S.1609, would be encouraged to permit activities that would promote competition among all companies, whether or not depository institution holding companies, engaged in financial activities.

ANSWER to 2(b)

Certain data processing activities are already permissible for bank holding companies since the Federal Reserve Board has determined that they are closely related to banking and a proper incident thereto. Currently, permissible data processing activities include those for internal operations of the holding company or its subsidiaries and, with respect to any other customer, those involving financial, banking or economic data. Under the bill, the Federal Reserve Board would have the authority to determine whether additional data processing services would be permissible under either the "closely related to banking" test or the "financial nature" test. However, it is impossible at this time to predict what new data processing services would be permissible or what the parameters of those services would be.

ANSWER TO 2(c)

In general, the proposed legislation decreases the powers of unitary savings and loan holding companies (SLHCs) and savings and loan service corporations and increases the powers of multiple SLHCs as summarized below.

Unitary SLHCs

Currently, the activities of unitary SLHCs are virtually unrestricted. The bill would grandfather all current activities of unitary SLHCs but prohibit any activities not specifically authorized by the bill or by the Federal Reserve Board through regulation. In this way, the bill would equalize the permissible activities of all depository institution holding companies and maintain the separation between commerce and banking. For example, under the bill a unitary SLHC, such as Sears, could not enter a new nonfinancial business unless it divested its subsidiary thrift.

Multiple SLHCs

The activities currently permissible for multiple SLHCs include: performing management services for a subsidiary FSLIC insured thrift; conducting an insurance agency or escrow business; holding, managing, or liquidating a subsidiary FSLIC insured thrift's assets; holding or managing properties of an FSLIC-insured thrift subsidiary; acting as trustee under a deed of trust; and engaging in activities determined by the FSLIC to be a proper incident to the operations of thrifts (principally real estate activities). The bill would expand these permissible activities to include: insurance underwriting and brokerage; the activities of a depository institution securities affiliate; activities determined by the Federal Reserve Board to be of a financial nature or closely related to banking; the acquisition of shares of an export trading company; the acquisition of shares of an FDIC-insured bank. The bill would also maintain the authorization of SLHCs to engage in the activities in which multiple SLHCs may engage directly on July 1, 1983, provided that in the case of real estate investment and development, a savings and loan holding company may only maintain its investments lawfully held on July 1, 1983, and make additional investments that do not increase the total amount of the holding company's investment in those activities above 5 percent of its consolidated primary capital.

Service Corporations

The bill would permit service corporations of Federally-chartered mutual institutions to maintain all existing activities and to expand in the future pursuant to service corporation authority available to them on July 1, 1983, whether or not they were engaged in any such activity on that date. Those authorities include unlimited real estate investment and development; financial options; trading; credit card operations; etc. State-chartered institutions would not be limited by the service corporation provisions of the bill and could thus conduct any service corporation activities authorized by the states. They would, however, be authorized under the bill to operate a service corporation under the Federal provisions notwithstanding that state law did not permit service corporations.

Service corporations of Federal stock S&Ls could continue to engage in any activities that they engaged in on July 1, 1983, but they could not engage in any new activities other than ones specified in the bill, which are mainly clerical and nonretail in nature, (*i.e.*, check deposit sorting and posting, credit information, etc.). The activities that could no longer be conducted in a service corporation, if they are new activities for the Federal stock S&L, would include: making consumer loans; providing tax return preparation services; acquiring, maintaining, managing and developing real estate; and insurance agent or broker services. Under the bill, Federal stock S&Ls could expand into new activities, beyond the clerical and nonretail type, through a holding company. Investments in such holding company activities would not be subject to the 3 percent of assets limitation that is applicable to service corporation investments under current law.

The service corporations of mutual and stock S&Ls would be treated differently because mutual institutions cannot form holding companies.

ANSWER to 2(d)

S. 1609 permits the expanded powers to be conducted through the holding company itself as well as in a separate subsidiary of the holding company because in either case the depository institution, and thus the Federal deposit insurance system, is insulated from activities that may be riskier than banking. Risks accepted by a parent holding company or a subsidiary of the holding company affect the depository institution only indirectly; i.e., the depository institution does not own the holding company or the holding company subsidiary, and its transactions with the parent and/or affiliates are very limited by percentage limitations, collateral requirements, and other restrictions.

QUESTION 3

A major purpose of the Treasury proposal is "to promote increased competition" in the financial services industry. Do you believe that there is now a significant lack of competition in the securities, insurance, and real estate areas? For example, do you think there are significant economic or legal barriers to entry in these areas? Are numbers of competitors presently too small to allow adequate competition in these fields?

ANSWER

The competitive problem that we see is that there are legal barriers preventing depository institution organizations from entering the securities, insurance, and real estate areas, rather than any significant lack of competition within those areas themselves. Thus, depository institution organizations are at a severe competitive disadvantage in not being able to offer a full range of financial services to their customers as are other nonregulated firms.

Securities and insurance firms, as less regulated segments of the financial services industry, are able to diversify the services they can offer consumers by forming multiproduct firms. They may even acquire "nonbank" banks and thrifts, thereby further broadening their range of available services. Most bank organizations and many thrift organizations are, however, limited in the range of services they can offer, and their ability to compete successfully is thus reduced. Depository institutions must be able, if they choose, to combine into diversified financial service organizations to compete in a radically restructured market.

The impetus to introduce this deregulation proposal stems, then, not from a feeling that there is too little competition in some financial service sectors, but rather from a desire to remove the anti-competitive barriers existing between depository institutions and other sectors of the financial services industry. The result will be increased competition, but this competition will benefit consumers and further promote the efficient allocation of resources within the economy.

QUESTION 4

The Treasury's advocacy of the "separate subsidiary" approach consists, at least, of a tacit admission that conflicts of interest and tie-ins are a potential problem with bank entry into new areas of businesses. From your experience both in industry and in government, would you please explain in some detail the conflict of interest and tie-in potential that your proposal seeks to address by requiring a separate subsidiary?

ANSWER

Although the primary policy objectives of the holding company approach are to insulate banks and thrifts from the risks of nonbanking activities, to eliminate competitive disparities arising from lower cost of funds and favorable tax treatment, to permit equivalent regulation of functionally equivalent activities, and to resolve inconsistencies and anomalies in the current scheme of regulation, this approach may also serve to protect against the potential for tie-ins and conflicts of interests because of laws limiting transactions between affiliates of a holding company. In this connection, the bill contains provisions that are intended to deal specifically with conflict of interest and tie-in abuses. These provisions supplement current restrictions on banks' and thrifts' transactions with affiliates by broadening private authority to enforce the anti-tying prohibitions applicable to both types of institutions.

Section 23A and proposed Section 23B of the Federal Reserve Act are designed to prevent conflict of interest abuses between banks and their holding company affiliates. As you are aware, last year's Garn-St Germain Act significantly revised Section 23A of the Federal Reserve Act, which restricts transactions between Federally-insured banks (member and nonmember) and their affiliates. Section 23A is designed to prevent the misuse of bank resources stemming from non-arm's length transactions between commonly controlled companies. It limits a bank's transactions (*i.e.*, extensions of credit and transactions having the effect of funding the affiliate) with any single affiliate to 10 percent of the bank's capital and surplus, and with all affiliates to 20 percent, and requires that all such transactions be fully secured. The Garn-St Germain Act made the Section 23A limitations applicable to REITs and investment companies advised by the bank, both of which previously were excluded from coverage. The Act extended the 23A limitations to all assets purchased by a bank, except those specifically exempted by the Federal Reserve Board, and to any guarantee, acceptance, or letter of credit on behalf of an affiliate. Section 23A also was amended to prohibit a bank from purchasing "low-quality" assets from any affiliate. In addition, amended Section 23A substantially liberalized the list of eligible collateral for transactions between a bank and its affiliates. Finally, all such transactions now must be on terms consistent with safe and sound banking practices.

Section 15 of our bill amends the Federal Reserve Act by adding a new Section 23B to further restrict transactions between a bank and its affiliates. New Section 23B provides that a member bank and its subsidiaries may engage in certain transactions with an affiliate only if the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with non-affiliated companies. If there are no comparable transactions, the terms and conditions of the transaction must be the same as those that, in good faith, would be offered to or would apply to nonaffiliated companies. Transactions subject to this limitation are:

(1) any covered transaction, as defined in Section 23A, with an affiliate;

(2) a sale of securities or other assets, including assets subject to an agreement to repurchase, to an affiliate;

(3) the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise;

(4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; or

(5) any transaction or series of transactions with a third party if (A) an affiliate has a financial interest in the third party, or (B) an affiliate is a participant in such transaction or series of transactions.

Section 23B also prohibits a bank and its subsidiaries from purchasing as fiduciary any securities or other assets from an affiliate, unless such purchases are authorized by the instrument creating the relationship, by court order, or by the law of the jurisdiction under which the trust is administered. The section also prohibits a bank and its subsidiaries, whether acting as principal or fiduciary, from knowingly either purchasing or acquiring, during the existence of any underwriting or selling syndicate, any obligation for which an affiliate or subsidiary of the member bank is a principal underwriter.

Under the Savings and Loan Holding Company Act, a thrift subsidiary of a savings and loan holding company ("SLHC") is prohibited from engaging in certain transactions with its affiliates. Specifically, the thrift is prohibited from investing in the securities of an affiliate or accepting such securities as collateral; purchasing assets or obligations under a repurchase agreement from any affiliate; extending credit to an affiliate, or to a third party if an affiliate will benefit from the proceeds; and guaranteeing repayment of loans or maintaining compensating balances for an affiliate. There are minor exceptions from these provisions. The proposed bill excepts from these prohibitions transactions between a thrift and an affiliate engaged in the activities newly permitted under the bill and subjects such transactions to the 23A and 23B requirements.

With regard to the possibility of tie-in abuses, we recognize that individuals and businesses depend to a great extent on depository institutions because of their importance as lenders and their pervasive involvement in finance. This relationship may give banks and thrifts greater leverage over their customers than other businesses. To prevent abuses of this relationship, the Bank Holding Company Act and the Home Owners' Loan Act currently prohibit banks and thrifts respectively from providing services for extending credit subject to the condition that the customer obtain additional services from the bank or thrift, or their holding companies, or affiliates. These laws also prohibit a bank or thrift from providing a service on the condition that a customer not obtain some service from a competitor of the bank or thrift. Finally, these laws provide authority for persons to sue for and obtain injunctive relief and treble damages in connection with violations of the anti-tying provisions. Because the risk of tie-ins may be greater if banks and thrifts can engage in the securities, insurance, real estate and financial activities proposed under our bill, the bill adds provisions permitting a trade association to commence, on behalf of a member, any private right of action for injunctive relief against threatened loss or damage resulting from a violation of the anti-tying prohibition. The new provision is intended to permit trade associations to bring actions on behalf of their members, and thus to encourage maximum enforcement of these provisions through private actions in addition to enforcement by supervisory agencies.

QUESTION 5

S. 1609 would add a new Section 23B to the Federal Reserve Act in order to impose greater restrictions on transactions between a member bank and its affiliates than are now provided by Section 23A. While there is probably a need to have the additional restrictions of 23B to cover transactions with affiliates engaged in the new activities that are being authorized by S. 1609, I question the need to impose these additional restrictions on affiliates engaged in existing nonbank activities.

a. Since S. 1609 gives the Federal Reserve Board the authority to exempt affiliates from 23B and you state in the section-by-section analysis that you expect the Board will exclude subsidiaries engaged in existing nonbank activities, why did you not just directly exclude them by statute?

b. Last year the Congress amended Section 23A and in so doing believed that it provided adequate protections for transactions with existing nonbank subsidiaries. Has anything happened since then so that 23A is no longer adequate to deal with existing nonbank subsidiaries?

ANSWER to 5 (a)

Given the purposes of proposed Section 23B of the Federal Reserve Act, i.e., protecting a bank from potential abuse and providing competitive equality for all nonbank entities engaged in an activity, we believe that it is appropriate to provide the Federal Reserve Board with the flexibility to exempt certain nonbank activities, including existing activities, from coverage of Section 23B, while not mandating such an exemption. This approach would provide the ability for the Federal Reserve to address problems in the future that we cannot accurately foresee at this time. It is possible that a current activity of an affiliate poses no problems for a bank in terms of transactions between the two, but future changes in an affiliate's operations, services, or products may require that such an affiliate be subject to all of the protections of Section 23B. Thus, we believe it is appropriate to provide regulatory authority, which is much more flexible than a statute, in order to address such problems.

ANSWER to 5 (b)

Last year when the Congress was considering amendments to Section 23A of the Federal Reserve Act, the Treasury Department worked with the Federal Reserve Board, Congressional

Staff and the banking industry to try to expand the protections of proposed Section 23B to all transactions between a bank and its affiliates. Since that time, no changes have occurred to make Section 23A inadequate to deal with existing nonbank affiliates. We continue to believe, however, that Section 23A is not as complete as it should be to properly protect a bank from potential abuse. As discussed above, we believe that additional restrictions on all transactions between a bank and it affiliates are appropriate even though affiliates engaged in existing nonbank activities may be exempted by regulation from such restrictions.

QUESTION 6

The proposed Section 23B would prohibit a bank and its affiliate from advertising or suggesting that the bank is in any way responsible for its affiliate's obligations. However, it permits a bank and its affiliate to use the same name. Would that not suggest to the general public that the bank and securities affiliate bearing the same name are one and the same?

ANSWER

If a bank and its affiliates used the same name, we recognize that the general public may perceive them as the same entity. However, our primary concern is to preserve the competitive advantage to these firms of permitting them to use the same name.

Such organizations as Sears and Merrill Lynch currently combine financial and securities activities without any requirements for separate names for the performance of all these services. Provisions requiring separate names for subsidiaries within a bank or thrift holding company would be unduly restrictive and would offset pro-competitive aspects of expanding holding company participation in other activities, and we therefore do not support such provisions. The proposed legislation is designed to place bank and thrift holding companies on a competitive par in every respect possible with other multiproduct financial firms.

Despite use of the same name, a bank and its affiliates would be legally distinct entities within the holding company. The holding company structure therefore provides important safeguards to the public. Since a bank can have no direct equity investment in any of its affiliates, consumers' funds in a depository institution would be protected and insured regardless of the success of affiliates' activities. Consumers assume, therefore, no greater financial risk in dealing with a bank and its affiliates than they would in dealing with several different financial service organizations.

QUESTION 7

Many contend that the bank experience with real estate investment trusts during the 1970s invalidates the Treasury approach to expanding bank powers. How would you address that charge?

ANSWER

In the 1970s, certain bank holding companies organized and sponsored real estate investment trusts (REITs). Neither the holding company nor its subsidiary bank directly invested in the REIT. At that time, the REIT was considered neither an affiliate for purposes of Section 23A of the Federal Reserve Act, nor a subsidiary for purposes of the Bank Holding Company Act. Since a REIT sponsored by a holding company was not an affiliate of that holding company's subsidiary bank for Section 23A purposes, the loans between the REIT and the bank were not subject to the collateral requirements or other restrictions of 23A regarding extensions of credit or the purchase of assets. Such transactions were subject to the much less restrictive general standards that they not constitute an unsafe or unsound banking practice or a misuse of bank assets. The fact that a REIT was not considered a subsidiary of the bank holding company that sponsored it further exacerbated the problem since the REIT was not subject to the examination, regulatory, and supervisory authority of the Federal bank regulators. Thus, problems could continue undetected. In view of the above, banks were able to continue to lend to REITs as they developed significant financial problems due to the real estate market collapse of the 1970s. As the financial problems of the REITs increased, so did the bank loans to them. Therefore, when the REITs failed, banks sustained substantial losses.

In contrast to the REIT situation of the 1970s, the Administration's proposed bill permits bank holding companies to engage in real estate development directly or through a nonbank subsidiary. Under this proposal, the holding company would invest in, rather than sponsor the real estate development company. All transactions between the real estate company and its affiliated bank would be subject to the requirements and restrictions of Section 23A as well as to the arms' length requirement of proposed Section 23B. In addition, the real estate company would be part of the bank holding company system and would therefore be subject to regulation, supervision, and examination by the Federal Reserve Board. Finally, as an added precaution to ensure that bank holding companies proceed slowly in becoming involved in real estate investment and development, there is a maximum investment limitation in the proposal of 5 percent of the holding company's capital that may be invested in such activities.

QUESTION 8

Is the Treasury proposal equally a way to expand banking and thrift powers and a way to allow outsiders to compete in traditional banking markets?

ANSWER

Yes. In recent years, because the regulatory and statutory restrictions on banking and thrift powers made these institutions unable to provide the types of financial services that customers wanted, nonregulated, nondepository institutions began offering bank-like services, *i.e.*, money market funds, cash management programs and lines of credit. The Administration's bill should help to equalize the competitive position of the depository and nondepository financial institutions by allowing banks and thrifts to enter traditional securities industry activities on a limited basis and by closing the nonbank bank loophole that has allowed nondepository institutions to take advantage of bank powers and yet avoid the regulatory and statutory restrictions that apply to banks.

Under the Administration proposal, outsiders would also be allowed to compete in traditional banking markets by acquiring banks, provided that the outsiders are engaged only in the activities permitted by law, including the activities newly permitted under the proposal. Thus, for example, an insurance company or a mutual fund would be authorized under the proposal to purchase a bank. This is not authorized under current law.

Answers to Questions Submitted by Senator Proxmire

QUESTION

Chairman Volcker in his July 5 letter commenting on the Treasury bill said the Fed may send up amendments that would change the laws establishing geographic limitations on banking activities, i.e., McFadden & Douglas.

- What do you think about changes to such laws?
- Could not such changes result in increased aggregations of financial and political power?

ANSWER

The Administration favors renewed Congressional efforts to eliminate restrictions on the geographic expansion of depository institution activities. Most such restrictions serve only anticompetitive purposes to the detriment of consumer service and convenience. We recognize the long and difficult process involved in dealing with legislation on this very controversial issue, but we are prepared to work with the Banking Committees to deregulate restrictive geographic barriers if there are reasonable prospects for the passage of such legislation.

In the Bank Holding Company Act of 1956, no limitations were placed on the operation of nonbank activities across state lines if they were so closely related to banking as to be a proper incident thereto, such as consumer lending, mortgage banking, etc. In 1981 a statutory moratorium on the interstate operation of trust companies was allowed to lapse, permitting trust operations interstate. And last year the Garn-St Germain Act authorized the acquisition of failing depository institutions across state lines by other healthier organizations.

At the same time many states are easing or eliminating their restrictions on the interstate activities of depository institutions. Several New England states have authorized interstate operation of institutions headquartered elsewhere in that region. The Administration believes that local governments familiar with local markets should be able to make sound decisions about their regional economy. Moreover, the strengthening of local institutions prior to a removal of all geographic restrictions nationwide facilitates the potential for development of more organizations able to compete nationally when the opportunity arises.

The Administration would prefer the earliest possible resolution of a nationwide policy for interstate banking activities. It seems to us that the pro-competitive benefits to be had from such a policy evenly applied to all depository institutions argue for precedence over regional interstate banking.

Easing statutory geographic restrictions on depository institutions' activities might result in some increased aggregation of financial and political powers. However, the legislative changes would simply formally authorize the erosion of restrictions on interstate activities of depository institutions that have already occurred in the marketplace. Commercial lending, consumer lending and limited deposit taking from retail customers already transcend state lines through the use of out-of-state loan production offices, credit cards and electronic funds transfers. Improved technology has considerably expanded the distances over which business can be conducted from a single location.

QUESTION

* Since many large banks are already overextended with their loans to foreign countries and under-capitalized, do you see any danger in allowing the banks to expand their activities into new businesses at this particular time?

ANSWER

No. It is not the banks themselves that would be permitted to expand into new businesses under the proposed bill. The new businesses can only be conducted through the bank's parent holding company or any nonbank subsidiary of the holding company. Thus, banks, as separate corporations, would be insulated from the risks of these new activities. If a holding company subsidiary went bankrupt, the holding company would sustain a loss, but the bank and the holding company's other subsidiaries would not be substantially affected. Even if the holding company went bankrupt and its assets, including shares of the bank, were distributed to new owners, the bank's safety and soundness would not be jeopardized.

In addition, Section 23A of the Federal Reserve Act and new Section 23B in the proposed bill further protect the banks since they restrict transactions between the bank and its affiliaties. This would prevent the bank from overextending itself in support of an affiliate.

Finally, some would argue that the activities we have proposed may actually be less risky than the current loan portfolios of many banks. Thus, the new activities may reduce overall risk to the holding company and provide troubled banks with a new source of capital from profitable affiliates.

QUESTION

During the early and mid 1970s, many large bank holding companies got into financial difficulty with their investments in REITs even though these were organized as separate affiliates.

* What makes you believe we will not have a repetition of this experience if Congress allows bank holding companies to get into the real estate development business as recommended in your legislation?

ANSWER

In the 1970s, certain bank holding companies began organizing and sponsoring REITs (real estate investment trusts). Neither the holding company nor its subsidiary bank would directly invest in the REIT, and at that time the REIT was considered neither an affiliate for purposes of Section 23A of the Federal Reserve Act, nor a subsidiary for purposes of the Bank Holding Company Act. Since a REIT sponsored by a holding company was not an affiliate of that holding company's subsidiary bank for Section 23A purposes, the transactions between the REIT and the bank were not subject to the collateral requirements or other restrictions of 23A regarding extensions of credit or the purchase of assets. Such transactions were subject to the much less restrictive general standards that they not constitute an unsafe or unsound banking practice or a misuse of bank assets. The fact that a REIT was not considered a subsidiary of the bank holding company that sponsored it further exacerbated the problem since the REIT was not subject to the examination, regulatory, and supervisory authority of the Federal bank regulators. Thus, problems could continue undetected. In view of the above, banks were able to continue to lend to REITs as they developed significant financial problems due to the real estate market collapse of the 1970s. As the financial problems of the REITs increased, so did the bank loans to them. Therefore, when the REITs failed, banks sustained substantial losses.

In contrast to the REIT situation of the 1970s, the Administration's proposed bill permits bank holding companies to engage in real estate development directly or through a nonbank subsidiary. Under this proposal, the holding company would invest in rather than sponsor the real estate development company. All transactions between the real estate company and its affiliated bank would be subject to the requirements and restrictions of Section 23A as well as to the arms' length requirement of proposed section 23B. In addition, the real estate company would be part of the bank holding company system and would therefore be subject to regulation, supervision, and examination by the Federal Reserve Board. Finally, as an added precaution to ensure that bank holding companies proceed slowly in becoming involved in real estate investment and development, there is a maximum investment limitation in the proposal of 5 percent of the holding company's capital that may be invested in such activities.

QUESTION

Your proposed bill allows bank holding companies to engage in "services of a financial nature" in addition to the services specifically listed.

* What do you intend would be covered under this phrase that would not meet the "closely related to banking" test now contained in current law?

ANSWER

Activities "of a financial nature" would include a broader range of financial services than those "closely related to banking", reflecting the increasing homogeneity of financial service firms, the intent that depository institutions be able to compete equally with these firms, and the benefits to consumers that would result from increased competition.

Under current law, an activity is considered permissible for bank holding companies to engage in if it is "so closely related to banking or managing or controlling banks as to be a proper incident thereto". In examining an activity under this standard, the Federal Reserve Board performs a two-step analysis. First, it considers whether the activity is "closely related to banking", relying primarily on the standard set forth by the D.C. Court of Appeals in National Courier Assn. v. Board of Governors, 516 F.2d 1229 (D.C. Cir. 1975). The Court viewed as relevant to the closely related test, whether banks generally have in fact provided the proposed services; whether banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services; or whether banks generally provide services that are so integrally related to the proposed services as to require their provision in specialized form. The second step of the analysis, the "proper incident" test, is to determine whether the performance of the proposed services by bank holding companies would be generally in the public interest. An activity is only considered permissible if both these tests are met. Thus, the current standard affords little opportunity for expansion that would keep pace with innovations in the financial services industry.

As stated in the section-by-section analysis of the bill, the Federal Reserve Board, in defining activities of a financial nature, is directed to give primary consideration to the public benefits that would result from increased competition among all companies, whether or not depository institution holding companies, engaged in activities of a financial nature. Dramatic changes are taking place in the financial services industry. Distinctions that have previously existed between banking and nonbanking services are becoming increasingly outmoded. Nondepository institutions now offer services that compete with traditional banking services. Nonbanking diversified firms such as Sears-Roebuck and Co., Merrill Lynch and Co., and Shearson/American Express are rapidly approaching the point where they can offer onestop financial shopping. It is intended that the Federal Reserve Board, in recognition of these changes, define "activities of a financial nature" in such a manner as to enable bank and savings and loan holding companies to offer a broader range of services that will compete with those offered by other companies not regulated to the same extent as depository institutions and their holding companies.

QUESTION

The legislation you have submitted would allow banks to own thrift institutions and vice versa.

* What do you believe would be the effect on the supply of home mortgage credit if these combinations were allowed, and what studies, if any, has the Treasury made on this issue.

ANSWER

To clarify a technical point, it should first be noted that our proposal would not allow banks to own thrift institutions and vice versa. Rather, the legislation permits a bank holding company to own one or more thrift institutions and a thrift holding company to own one or more banks.

We have not conducted any studies specifically on the impact of the proposed "Financial Institutions Deregulation Act" on home mortgage credit. However, two major interagency task force studies have examined the regulatory environment of the thrift industry and the ensuing impact on housing credit. These studies, "Deposit Interest Rate Ceilings and Housing Credit" (1979) and "Report of the Interagency Task Force on Thrift Institutions" (1980), looked at the influence of interest rate ceilings and restricted asset powers on thrift institutions. These restrictions were instituted with the intent of facilitating the flow of funds to housing, and they have historically been somewhat effective in achieving this objective. However, in light of today's volatile interest rates and rapidly evolving financial markets, the studies show these restrictions to be a hindrance to the competitive viability of thrift institutions, thereby interrupting the flow of funds to housing.

Pursuant to the "Depository Institutions Deregulation and Monetary Control Act of 1980" and the Garn-St Germain Act of 1982, most interest rate ceilings have now been eliminated and the asset powers of thrifts have been significantly expanded. These actions are seen as necessary steps to make the thrift industry more competitive, and a strong and viable thrift industry is seen as the key to ensuring adequate levels of home mortgage lending.

It was feared by some groups that expanded asset powers might divert thrifts from the primary business of home mortgage lending. However, this shift in emphasis has not occurred. Rather, expanded asset powers have strengthened thrifts by enabling them to diversify their portfolios and to create a better match between the maturities of assets and liabilities.

In like manner, some might fear that allowing a bank holding company to own a thrift institution might lead to redirecting funds for housing into other activities. Under our proposal, banks and thrifts may remain separate corporate entities within the holding company system, and will therefore not commingle their funds. Furthermore, the restrictions on interaffiliate transactions, which are applicable to both banks and thrifts, will protect against such abuses. In addition, tax advantages applicable to thrifts that concentrate their lending in the home mortgage area will encourage thrifts to make home mortgage credit available.

We view our current proposed legislation as an additional means of buttressing the thrift industry by attracting new capital and a broader range of customers through the holding company framework. This action should help thrifts to maintain their speciality of home mortgage lending as a viable business.

We do not foresee that our proposal will jeopardize the flow of funds to mortgage credit. Indeed, the Administration would not propose a bill that it believed would result in less mortgage lending. Thrifts should retain the advantage of specialization in mortgage lending while reaping the advantages of diversification.

QUESTION

Suppose a large bank holding company purchased a large life insurance company which in turn had extensive equity investments in various businesses and real estate developments.

* What safeguards would there be to prevent the bank from making unwise loans in order to support the equity investments of its insurance affiliate?

ANSWER

First, it should be noted that any acquisition by a bank holding company could only involve a company engaged in activities permissible under the Bank Holding Company Act, including limited investment in real estate development activities. Therefore, if the life insurance company's investments in real estate development exceeded the maximum 5 percent of the bank holding company's capital, the bank holding company could not acquire the insurance company.

The bill would add a new Section 23B to the Federal Reserve Act. This section, together with existing Section 23A of the Federal Reserve Act, places restrictions on transactions between a bank and its affiliates. The provisions also restrict transactions with third parties to the extent the transaction benefits the affiliate. Such transactions may be made only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for transactions involving nonaffiliated companies. In this manner, the bank would be safeguarded from making loans that could jeopardize its soundness.

QUESTION

Suppose a bank holding company had a real estate brokerage company. The salesmen of that company are naturally eager to make sales and to qualify their customers for financing.

* What assurance is there that the affiliate bank will not make improvident mortgage loans to marginal buyers at the behest of its real estate salesmen?

ANSWER

New Section 23B of the Federal Reserve Act, which is applicable to all Federally-insured banks, would permit a bank and its subsidiaries to extend credit only on an arms-length basis in a transaction, such as the one you describe, in which an affiliate of the bank acts as an agent or broker. Thus, the credit standards and the terms of such a loan could be no more favorable to the affiliate's real estate buyer than are otherwise available in the market.

QUESTION

The proposed bill would allow bank holding companies to underwrite and deal in municipal securities including revenue bonds. In addition, it allows bank holding companies to "conduct a government and municipal securities business."

* What is included in this phrase that would not be covered in the authority to underwrite and deal in municipal securities?

ANSWER

Page 2 of the Section-by-Section Analysis states that depository institution securities affiliates would be empowered both to "deal in and underwrite U.S. government and municipal securities" and to "conduct a government and municipal securities business." The latter phrase includes no additional authority beyond that required to deal in and underwrite U.S. government and municipal securities. It simply makes explicit the fact that a depository institution securities affiliate may engage in activities incidental to its business of underwriting and dealing.

QUESTION

Your bill would place new restrictions on the so-called unitary savings and loan holding companies -- that is, those companies that own only one savings and loan association such as Sears. As I read your bill, Sears would have to give up its savings and loan association were it to engage in a single new activity that it was not doing as of July 1.

* What assessment have you made of the impact of this requirement on savings and loan holding companies that would be affected?

ANSWER

The Administration's bill would place new restrictions on the activities of unitary savings and loan holding companies by treating them the same as multiple savings and loan holding companies. Thus, companies engaged in activities other than those authorized under the bill could not become part of any savings and loan holding company. However, the grandfathering provision in Section 19 of the bill authorizes a holding company that was a unitary savings and loan holding company on July 1, 1983, to continue to engage in any activity in which it was lawfully engaged on that date. Such a holding company (including your example, Sears) could continue to expand its existing FSLIC-insured subsidiary through branching and, subject to the bill's conditions and limitations, engage in any new activities permitted by the bill. A grandfathered savings and loan holding company would, however, lose its grandfather privileges if (1) the FSLIC-insured subsidiary lost its qualification under the Internal Revenue Code; (2) the grandfathered holding company acquired an FDIC-insured bank; or (3) the grandfathered holding company began new activities, other than those permissible for savings and loan holding companies under this bill.

The impact of this requirement on savings and loan holding companies would be to bring unitary holding companies under the same restrictions as multiple savings and loan holding companies and bank holding companies.

MORATORIUM LEGISLATION AND FINANCIAL INSTITUTIONS DEREGULATION

TUESDAY, SEPTEMBER 13, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Mattingly, Hecht, Trible, Proxmire, Riegle, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order. Today we continue hearings on legislation regarding changes in the financial system, which were raised and discussed during the committee's recent oversight hearings on the financial services industry. The principal focus of these legislative hearings is the administration's comprehensive Financial Institutions Deregulation Act, S. 1609. We will also review the Federal Reserve's nonbank, bank moratorium bill, S. 1532, other proposals for regional interstate banking, the payment of interest on reserve balances and checking accounts, and the FDIC proposal, S. 1682, to reinforce Glass-Steagall type prohibitions and require divestitures of nonbank banks. In general we will be addressing the issue of how Congress can resolve the problems and charges that are occurring so very rapidly in the financial marketplace.

As I have said many times before, it is important that Congress should deal with all of the issues, and not attempt to solve the questions at hand by postponing their resolution. The purpose of these hearings is to let everyone have a chance to express their viewpoint and concerns about these proposals.

We began our hearings on these legislative proposals last July, with the appearance of Secretary Donald Regan of the Treasury, who testified in favor of the administration's bill and in opposition to a moratorium on nonbank bank activities. As I stated then, there is much in the administration's bill that I support, and there is much that I would like to know more about.

It is obvious the administration's bill has attracted both proponents and opponents. While the Treasury and the Federal Reserve have expressed support for it, some of the regulatory agencies have stated objections and some of the industries affected by it—insurance, real estate, and securities—have expressed opposition to it.

To this hearing process the committee will be able to discuss in detail all aspects of the bills, and reach conclusions as to the appropriate direction Congress should take in responding to our changing financial system. Even if we are unable to complete work on the legislation this year, the committee must proceed in order to have the benefit of these hearings, as we attempt to resolve these issues before Congress.

This morning we will hear from Chairman Volcker of the Federal Reserve Board and from Chairman Gray of the Federal Home Loan Bank Board. Tomorrow we will hear from Chairman Isaac of the Federal Deposit Insurance Corporation. He will be followed by Todd Conover, the Comptroller of the Currency.

Mr. Proxmire, do you have any opening statements you wish to make?

OPENING REMARKS OF SENATOR PROXMIRE

Senator **PROXMIRE**. I don't have any formal opening statement, Mr. Chairman. I would just like to say that I am delighted you are calling this hearing and I am very happy to have as our first witness the Chairman of the Federal Reserve Board.

I think there's a need for prompt action. I am afraid, we are letting the situation drift, and because of the momentum of the marketplace, this is likely to result in bank acquisitions that make very little sense. It's also unfortunate this is happening without any input by the Congress, without any logical notion of how these acquisitions would affect the overall fairness and justice of the marketplace, and the other values that we do have. So I hope that we cannot only have good hearings, but followup with legislation as promptly as possible.

The **CHAIRMAN**. Thank you.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. **VOLCKER**. Mr. Chairman, I appreciate the opportunity to be back before you to discuss these controversial and difficult matters. I think it is very important we act. I have a long prepared statement, which I will not read, but I might just review its basic points.

SUPPORT TEMPORARY MORATORIUM

First, it reiterates the need for early action. I think we are at a point where we either turn the system toward creative innovation, consistent with some enduring policy objectives, or continue to see it evolve in a haphazard and potentially dangerous way. That choice obviously should be made in a constructive direction. We do continue to support the moratorium, Mr. Chairman, for that very reason.

You indicated that it's uncertain as to how quickly you can act, but I hope you can act on the comprehensive bill and the comprehensive approach as soon as possible. But I suspect that's going to take months, and meanwhile things are going on that prejudice some of these issues. We do think that the enactment of a temporary moratorium will give you a little breathing room; while holding things in place only temporarily it will not delay, but indeed encourage, early and comprehensive action.

When we move beyond that moratorium issue, I do emphasize in my statement what we think are continuing needs of public policy, most fundamentally. We want to let the competitive processes work; that's the way we provide services in our economy and provide them efficiently. But, at the same time, we have a continuing, abiding interest in the safety and soundness of the banking system. That, of course, has been reflected in such so fundamental actions over the years as the establishment of the Federal Reserve and the FDIC; it's reflected more currently in the concern of this committee and others as to foreign lending in recent years and the need for appropriate supervisory restraints in that area. Balancing these considerations provides the legislative and policy challenge.

We do continue to believe that banks play a particularly key role in our financial system, indeed in the economy more generally, that they have benefited from certain public policies. There's a safety net built around banking. On the other side of that coin, there are continuing regulations on banks that may not be necessary or applicable to other institutions. The marketplace, technology, competitive pressures, do bring us to a point where a broadening of powers of banks—or, more generally, holding companies, including banks—seems appropriate. We see the necessity to strike a balance.

For our part, we do believe the administration bill, if we look at it as a whole, does provide a reasonable balance. We have broadly supported that proposal, as you indicated. We think, among other things, it would make possible a significant and even sweeping simplification in supervisory procedures applicable to bank holding companies, and it would allow them a broadly expanded range of financial activities. It also maintains the broad distinctions between banking and commerce that we think are fundamental, and it would prohibit or sharply circumscribe participation in certain financial areas.

Underwriting of corporate securities and real estate development, in particular, are areas that are characterized by particularly strong elements of risk for potential conflicts of interest. I must emphasize, too, that our support for the bill is predicated on the retention of the essential safeguards, including an adequate supervisory framework to protect the safety and stability of banking institutions and the banking system.

We have noted certain problem areas, with respect to the broader powers, and I will touch upon them just briefly. We also recognize the bill, broad as it is, does have certain areas of unfinished business, and I want to touch upon those as well.

CONFLICT OF INTEREST PROBLEM

Specifically, I raise some questions in my prepared testimony about the conflict of interest problem; the more activities that bank holding companies engage in, the more possibilities there are for conflicts of interest and tying arrangements. I would point out to you that existing law prohibits a bank from engaging in tying arrangements with its subsidiaries. The Treasury bill leaves that provision intact; we assume it would continue. It is silent on tying provisions among other parts of the holding company.

You can make arguments that it is not necessary to protect against those in the same way, and that this may, indeed, be part of the natural competitive evolution of the supermarket concept of financial services. Nonbanking firms can engage in a variety of activities and do cross-selling, providing discounts for one service in return for purchase of another service. Indeed, we have a commercial firm in the savings and loan business that provides discounts on its housewares if you deal with other parts of that organization. But there is a kind of philosophical issue involved, and I think Congress would want to deal with that question in particular in approaching that issue.

We also have the possibility—not just the possibility, but the certainty—that if bank holding companies are in the insurance underwriting business, if they are in real estate development, even in a limited way, if they are in other areas, the bank holding company will presumably acquire an equity interest in a number of companies, and there is always thought to be some problem, some potential conflicts between an owner and a lender. That area of potential conflict will be broadened, and we suggest that one way of approaching this would be to limit or prohibit bank lending to any entity in which another part of the holding company has a substantial or a controlling ownership interest. There may be other ways of approaching the problem, but we think this is another area of potential conflict of interest that you would deal with.

In terms of risk in general, concern about safety and soundness, I would emphasize that in this bill the Federal Reserve is given, we believe, adequate authority to meet its concern with that question. When a bank holding company is making an acquisition, it would have to give notice to the Federal Reserve. It could be examined against the financial resources, the managerial resources of the bank holding company, and considerations of safety and soundness would enter into that.

We would also have general rulemaking authority as to types of activities, so that they could be limited as necessary from the standpoint of safety and soundness. We think those arrangements are generally satisfactory.

I would point out this would be done in a context of greatly simplifying the regulatory process. When a bank holding company now enters into a nonbanking area we have to determine net public benefits, and the burden of proof is upon the applying company to show that there are such net public benefits.

That presumption would be removed from the Treasury bill; notice would be given to us, the acquisition would proceed—unless we actually objected—and we would not have to make this finding of public benefits. I might also note that it takes the Federal Reserve out of antitrust concerns in approving applications. The antitrust laws would still apply, but presumably they would be a matter for the Justice Department and not the Federal Reserve in the future.

In the area of risk, we do have some concerns about real estate development, which are fundamentally reflected in the bill now by limiting the amount of investment in real estate development. We raise some questions about the necessity—particularly, perhaps, during a transitional period—for further limits which could be applied by regulation in that area.

In the insurance area, where we are satisfied that the risks themselves are managed, question of concentration of resources. We raise the question as to whether the Congress might—again, particularly during a transitional stage—limit the possibilities for the largest banks and insurance companies to amalgamate rapidly.

Instead, we suggest some limitations that would encourage banks to limit their insurance activities to small- or medium-sized insurance companies during some stage; or, if insurance companies wanted to acquire banks, they would limit their activities to small- or medium-sized banks for some period of time.

Those are all areas that are basically covered by the bill. There are areas that are not covered by the bill that I would bring to your attention, because we think they both require early action. First of all, an issue that has arisen really only in recent months, about Federal-State banking relationships. We have had regulation of bank holding companies by the Federal Government. We have had regulation of the banks on a dual basis, both by States and the Federal Government. We believe, by and large, that system has worked well over time.

STATES THREATEN UPSET BALANCE OF BANKING SYSTEM

But recently we have seen initiatives in some States to provide sweeping powers to their State-chartered banks that go far beyond anything that the Congress has authorized either for banks or bank holding companies. We think that threatens to upset the balance between the two systems, and also creates the possibility that, by State initiative—and with competition among States in the hope of getting jobs—fundamental protections in Federal law would be undercut. This is a difficult area to enter into, given our traditions, but we believe that the Congress has to face up to a need for action to define what is essentially a national issue of the powers and the scope of banking.

These banks are all protected by the Federal Reserve and the FDIC. The risks fall back on the Federal Government, in a sense, and within some broad framework, we think the Federal Government ought to set an appropriate framework and limit to the degree of State experimentation. That experimentation can be useful, but only, I think, within broad limits that are consistent with the banking philosophy of the U.S. Government itself.

A somewhat related issue is that of interstate banking. You are well aware that there's a good deal of interstate banking now, in various guises. But in many cases it takes rather unnatural channels, leads to distortion, leads to more risk than would otherwise be the case. Frankly, Mr. Chairman, we feel that the time has come when Congress ought to deal with this issue directly.

Technology itself presses in that direction, and we think it's important, again, that some national rules be set forth regarding terms and conditions that interstate banking can proceed in a more orderly way. There is a lot of activity going on at the State level now in that direction. We have more States permitting an interstate presence in one form or another. The situation is rather chaotic, and it seems to us it's going to remain that way unless the Congress takes initiative in setting some arrangements.

A lot of different transitional arrangements could be considered, and we would be happy to work with the committee and with others, if you deemed it appropriate to put together alternative proposals that work in that direction in any way you see fit.

Finally, you did raise the question of interest on demand deposits and reserves, and I have included some material in my statement on that. Generally, we favor moving toward paying interest on demand deposits and, over time, paying interest on reserves. On the latter point, we think it's important, in terms of equalizing competitive conditions among different suppliers of banking and banking-like services. It has some implications for monetary policy—it creates some distortions in monetary aggregates—once again, those would be transitional problems that can be dealt with.

It also has implications for Federal revenues. I think the principal problem you face is that payment of interest on reserves is a good idea conceptually, but it does have some budgetary implications that would bear upon the timing or phasing-in of such actions. As a fundamental matter, we do not believe that reserve requirements should be considered as a revenue measure; if you want to tax banks, you should do so straightforwardly, as an explicit decision, and not as a byproduct of reserve requirements. But, of course, we recognize there is a practical revenue problem at the moment.

This covers, in limited form, some large and highly controversial areas that are dealt with in more detail in my statement, Mr. Chairman, but I just wanted to highlight those issues now.

[The complete statement follows:]

For release on delivery
Expected at 9:30 A.M. EDT
September 13, 1983

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

September 13, 1983

I appreciate the opportunity to appear on behalf of the Federal Reserve Board before this Committee to review with you a wide range of issues affecting the evolution of banks, banking, and the financial services industry. The proposed "Financial Institutions Deregulation Act of 1983," submitted to you by the Treasury on behalf of the Administration provides a focus for these comments.

I testified before this Committee in the course of its general review earlier this spring, and I expressed then my conviction that Congress should now move to reform the existing legislative framework governing banking organizations to provide some assurance that the powerful forces of change be channeled in a manner consistent with the broad public interests at stake -- the need to maintain a safe and stable financial system, to assure equitable and competitive access to financial services by businesses and consumers, and to preserve an effective mechanism for transmitting the influence of monetary, credit, and other policies to the economy.

Nothing that has happened over the summer has reduced the need for early action -- quite the contrary. New combinations of firms in the financial services area, new services, and new combinations of older services are proceeding.

No doubt, much of this change reflects a natural, and potentially constructive, effort to respond to market incentives, customer needs, and new technology. What is so disturbing is that much of this activity is forced into "unnatural" organizational form by the provisions of existing law and regulation. The consequences are obvious and serious. In some cases, the services are less readily available, at higher cost, than would otherwise be the case. Important competitive inequalities exist, as some institutions are able to take advantage of loopholes or ambiguities in the existing legal fabric and others are not. And in some cases, important objectives of public policy embodied in existing law are threatened or undermined. The pervading atmosphere of unfairness, of constant stretching and testing of the limits of law and regulation and of circumvention of their intent, and of regulatory disarray is inherently troublesome and basically unhealthy.

As I emphasized in April, there can be no doubt that a reexamination of the existing legislative framework has become urgent. We are at a crucial point. We can turn the system toward creative innovation consistent with certain broad and continuing concerns of public policy. Or, left unattended, we can continue to see the financial system evolve in haphazard and potentially dangerous ways -- ways dictated not just by natural responses to market needs but by the often capricious effects of existing and now outmoded provisions of law.

When I was before you in April, I suggested a possible interim step of a temporary limitation on combinations of nonbank banks (and thrifts) with non-depository institutions, as well as a similarly temporary halt to new state authorizations of expanded nonbanking activities for state-chartered banks. This interim step still seems to me required to provide Congress with the minimum time necessary to decide on appropriate policy approaches rather than be faced with a multiplying number of faits accomplis, vastly complicating the job of orderly reform.

Since that time, other proposals have been made to limit acquisitions of banks and thrifts by nondepository institutions. The particular proposals of Chairman St Germain of the House Banking Committee and Chairman Issac of the FDIC are more sweeping, requiring divestiture of existing combinations, and represent permanent prohibitions. These proposals, as I understand them, are not set forth as immediate, practical legislative initiatives, but rather to emphasize the need for more forward-looking, constructive reform by indicating the logical alternatives to absence of such action.

All these proposals have as their fundamental premise that the present situation is untenable. I share that view. We must either move forward, or we must define more precisely, carefully, and equitably the boundaries of existing law dealing with the separation of banking and commerce and of activities within the financial sector. Simply waiting for the "dust to settle" where it will cannot be a satisfactory alternative. It is all too likely that the "dust" will fall unevenly and unfairly and impair the financial machinery. The moratorium proposal can provide only an imperfect, temporary shield while you work out a more forward-looking approach, but it would nonetheless serve the purpose of preserving your decision-making flexibility and of setting a deadline for more comprehensive Congressional action.

In that sense, I see it as a complement to, and not a substitute for, the initiative taken by the Administration to place before you a specific proposal for reform. We welcome that proposal, for it provides a constructive framework for your deliberations on a suitable approach to guide us over the next generation.

The remainder of my statement first restates the broad considerations and criteria that we feel should underlie any legislation and then, against that background, deals with more particular aspects.

General Considerations

The core objectives of banking and financial reform seem simple to cite. As in other areas, we want a system that encourages competition in the provision of banking and financial services; and consistent with those competitive processes, consumers and businesses -- small or large -- should be able to purchase financial services at minimal cost. By its nature, a banking system also needs to be responsive to the concerns of public policy, including the need for an effective transmission belt for monetary policy. Finally, throughout history, here and abroad, there has been special concern about the need to maintain confidence in the basic payments system, implying continuing attention to the safety and soundness of banks.

At the heart of the problem, in setting out an appropriate legislative framework, lies the fact that, in some circumstances, these easy-to-state, agreed objectives may be in conflict or point toward different approaches. We normally should and do look toward the marketplace -- free of regulations except those necessary to preserve competition -- to promote competition and efficiency. But when soundness, confidence, and continuity in the provision of money and payments services are at stake, deregulation cannot alone achieve the objectives because some degree of government support and regulation is implicit. The creation of the Federal Reserve and the FDIC -- and, more recently, our shared concern about the need for more intensified supervision of international lending -- are obvious cases in point.

In approaching that dilemma -- encouraging the free play of market forces while also recognizing the need to preserve a "hard core" of safety and soundness in the financial and payments system -- we have emphasized in earlier testimony several points as a basis for legislation:

1. We should continue to recognize that banks, and depository institutions generally, perform a unique and critical role in the financial system and the economy -- as operators of the payments system, as custodians of the bulk of liquid savings, as essential suppliers of credit, and as a link between monetary policy and the economy.
2. This unique role implies continuing governmental concerns -- concerns that may be reflected both in the support provided by lender of last resort and deposit insurance facilities and by regulatory protection against undue risk or bias in the credit-decision process.
3. A bank or depository institution cannot be wholly insulated from the fortunes of its affiliates -- their success or failure or their business objectives.

In essence, these essential points seem to us to set broad limits on the extent to which market and competitive forces alone can be relied upon to shape the evolution of banking organizations within the financial and economic system. For instance, they underlie the strong tradition in the United States of a separation between banking and commerce, although the precise line between the two needs to be reexamined in the light of changes in technology and other factors. It is precisely in drawing lines of this kind -- and in achieving an appropriate balance between legitimate and continuing regulatory concerns and the need to respond to competitive forces -- that difficult and controversial legislative choices must be made.

For our part, we believe the Administration bill, taken as a whole, provides a reasonable balance and we broadly support the proposal. It would make possible a significant -- even sweeping -- simplification in the supervisory procedures applicable to bank holding companies, and allow them a broadly expanded range of financial activities. But it also maintains the broad distinctions between banking and commerce, and would prohibit or sharply circumscribe participation in certain financial areas -- underwriting of corporate securities and real estate development -- characterized by particularly strong elements of risk or potential conflicts of interest.

I must emphasize that our support for the bill is predicated on the retention of the essential safeguards -- including an adequate supervisory framework -- to protect the safety and stability of banking institutions and the banking system. We have also noted certain problem areas with respect to the broader powers that I will be discussing in more detail. We also recognize the bill, encompassing as it is, would leave large areas of unfinished business. I will have comments on state-federal regulatory relationships and on the relationship between bank and thrift powers, both areas where further legislative direction is urgently needed.

Important questions have also been raised about the nature and role of deposit insurance in our evolving banking system -- a matter the FDIC and the FSLIC have themselves had under review -- and about the division of supervisory and regulatory responsibilities in the Federal Government -- a matter under study by the Bush Task Force. I do not in any way minimize the importance of these matters. My own sense is that your consideration of them might logically follow, rather than accompany, your consideration of the present Administration bill. Indeed, the sorting out of bank and thrift powers and Federal-State banking relationships would seem to be a prerequisite for intelligent approaches to the latter issues, and, as a practical matter, is added reason for dealing with the Administration bill promptly.

Bank Holding Company Regulation under the Administration Bill

With this background, I would now like to comment on the major provisions of the bill and how they affect new activities, the definition of bank, supervisory procedures, conflicts of interest, and avoidance of excessive risks. The

Board may wish to bring additional details to the attention of the Committee at a later time.

New Activities

The powers provisions of the Administration bill are its centerpiece, not only because they represent a major expansion in the types of activities in which banking organizations may engage, but also because they -- in combination with the definition of a bank contained in the bill -- will determine the types of nonbank firms that may own banks. Nonbanking activities of bank holding companies would be expanded to include, with the principal exception of corporate underwriting, not only those services "closely related to banking" but also those of a "financial nature". The bill would specifically authorize ownership of thrift institutions, insurance and real estate brokerage, real estate development (with limitations on the amount of capital investment), insurance underwriting, and certain securities activities if performed in a separate securities affiliate. These securities affiliates would be authorized to underwrite municipal revenue and certain types of industrial revenue bonds and to sponsor and underwrite money market and stock and bond mutual funds registered under the Investment Company Act.

The proposal thus draws the circle separating "banking" from commerce more broadly, but -- taking into account the cautionary comments on certain activities that I will detail below -- still within the bounds of what we believe is necessary to maintain safety and soundness and to avoid potentially harmful conflicts of interest, excessive concentration of resources, and undue risk -- the basic policy objectives which Congress has sought to attain through the Bank Holding Company Act.

Definition of Bank

The definition of the term "bank" is a key element in the bill because it defines the scope of institutions to which Congress wishes to apply these basic policies. The Administration proposal redefines the term "bank" to include: any insured bank, any institution eligible for FDIC insurance, and any institution that accepts transaction accounts and makes commercial loans.

This definition has attracted wide support. It is contained not only in the Administration bill, but also in our own moratorium proposal and the moratorium bills suggested by Chairman St Germain and the FDIC. This and other provisions would close the nonbank loophole and encompass other deposit taking institutions that could become vehicles for evasion of the policies of the Act. While a broadening of the scope of the definition beyond institutions that are federally chartered and insured should be carefully scrutinized to assure that we are not covering more than is necessary, it is our initial judgment that the broader definition is both necessary and desirable to assure we are not faced, within a short period of time, with the same kind of loophole evasions that are so troubling today.

Supervisory Procedures

Suggestions have sometimes been made that confining the conduct of new activities within nonbank subsidiaries of a bank holding company would itself adequately insulate the bank from risks or conflicts of interest involved in such activities, and therefore make feasible and appropriate virtually any activity within a bank holding company. As I have stressed before, the Board does not believe that this concept can achieve its objectives, although legal separation of parts of the holding company may be desirable to assist appropriate functional regulation and to help contain the elements of risk and conflicts of interest. We believe that the bill before you -- while placing operations of nonbanking activities in separate subsidiaries -- also provides adequate criteria for authorizing nonbanking activities and provision for supervision to the extent necessary. At the same time, unnecessary regulation would be eliminated, and there would be a major streamlining of the necessary supervisory procedures.

Present statutory procedures, in effect, require that a bank holding company, unlike other companies planning to enter a new line of business, be able to demonstrate to a public body -- the Board of Governors -- that there are positive net public benefits stemming from a nonbanking acquisition. This procedure affords competitors and other parties opportunities for comment, for hearing, and ultimate judicial review. In effect, the burden of proof is on the applicant and the process affords opportunities for costly and burdensome delay by competitors.

Under the proposed procedure, a bank holding company making an acquisition within the general framework of the permitted powers would still be required to submit a notice of such acquisition, but it could proceed unless disapproval by the Board of Governors was indicated within a limited time period on the basis of certain statutory considerations. Those statutory considerations -- adequacy of financial resources, adequacy of managerial resources, protection of impartiality in the provision of credit, and avoidance of any material adverse effect on affiliated banks' safety and soundness -- are designed to assure that certain longstanding purposes of the Bank Holding Company Act are maintained.

As a further measure to assure safety and soundness and fair competition with businesses in the same lines of activity, but not associated with banks, the bill also provides criteria be developed to require that nonbanking activities of banking organizations be capitalized at least as well as those of comparable competing business. At the same time, the provision in the present law that requires evaluation of competitive factors by the Federal Reserve would be deleted. The anti-trust laws would, of course, continue to apply and consequently, primary responsibility for anti-trust enforcement for bank holding companies, as for other companies, would shift to the Justice Department.

The law would permit the Board, by general regulation, to prescribe limitations on any new activities consistent with the four stated criteria and with safe and sound financial practices generally. The bill also provides adequate supervisory authority over the activities of the holding company and its nonbank subsidiaries after they are in operation. While encouraging reliance on reports required by other regulatory agencies to avoid duplication of reporting requirements, the Board is authorized to obtain further data if necessary to assess compliance with the Bank Holding Company Act and to institute procedures to assure compliance with law.

The net result of the new procedures should be to speed greatly the application process and to eliminate the possibility of dilatory tactics by competitors. At the same time, the Board believes that the statutory criteria and the framework for applying them are adequate to protect customers, the bank, and the financial system.

Conflicts of Interest

One of the major continuing concerns of the Congress in the Bank Holding Company Act has been to prevent conflicts of interest in the provision of credit. The objectives are several: the assurance of fair and open competition in the provision of credit; maintenance of the impartiality of banks in credit judgments; and avoidance of practices that could undermine the strength of the bank itself.

Those broad concerns remain real, but we also believe that extension of bank holding companies into new lines of activity -- combined with changing technology -- require reconsideration of the issue with respect to legislation and regulation. A single firm will be able to provide a much broader range of products to its customers -- that, indeed, is the driving force behind the proposal. This ability promises to provide the consumer with increased convenience through "one-stop shopping" for a range of financial services, and should increase his options.

At the same time, the natural tendency will be toward the joint offering of a variety of products, linked together in some significant way. For example, the combination of banking with real estate, insurance, mutual funds, and securities brokerage in one holding company makes it more likely that these products will be purchased in the same place, and inducements to purchase one service packaged with another offered at an attractive price are natural. We are already witnessing this process with the advertising by a major retail and financial firm that it will provide discounts on its household items if a customer purchases a home through that firm's real estate brokerage subsidiary.

There is no doubt that opportunities for tying, formal or informal, will exist if banking organizations are able to offer real estate, mutual funds, insurance and securities brokerage, together with traditional banking products. Because of concern about maintaining impartiality in the provision of credit, Congress enacted a specific prohibition, at the time it expanded bank holding company powers in 1970, on the tying or bank to nonbank services. Under the Administration proposal, these prohibitions would remain intact.

Our experience in administering these rules indicates that they are effective in preventing abuses of the bank that could endanger its financial stability. We assume that they continue essentially unchanged.

The Board, by regulation, has applied these same rules on tying to transactions involving the nonbank subsidiaries of bank holding companies. However, applying and enforcing such a regulation would become increasingly difficult as nonbank activities expand. Moreover, as indicated by the example above, other companies providing financial services are not inhibited by such rules. If the Congress chooses to encourage the supermarket of financial services concept, there is no reason why nonbank subsidiaries of bank holding companies should not be permitted to participate in this development on the same basis as other providers of financial services.

We would like to have direction from Congress about whether, in the framework provided by the Administration bill, prohibitions against tying should be maintained among nonbank subsidiaries of bank holding companies as well as against the bank itself. If so, it would appear competitively inequitable to have such strict rules apply (beyond services provided by a bank itself) while continuing to allow nonbank financial institutions the ability, through discounts and other means, effectively to tie their financial products.

Another area of potential conflict arises when a lender -- and particularly a bank lender and fiduciary -- has important ownership interests. In the past, any problem has been minimal in banking because of the strong limitations on equity investment by a bank and its affiliates. However, as a result of real estate development, insurance company and sponsored mutual funds activities, equity investments by a bank holding company would become much more significant in the future.

The provisions of the bill before you provide some basic protections against abuse of the bank. The bill does not authorize underwriting of corporate debt or equity securities, an area where the potential for conflicts of interest and risk may be particularly great. During an underwriting of securities handled by an affiliate, the securities involved could not be purchased by another affiliate, and the securities or other assets of an affiliate could not without authorization be acquired by another affiliate acting in a fiduciary capacity. The current safeguards on inter-affiliate transactions would be broadened beyond the present restrictions on the extension of credit to include complementary restrictions on the purchase of assets, the furnishing of services, and other transactions with a third party in which an affiliate has an interest, essentially requiring that these transactions be on non-preferential market terms.

These are useful provisions, but there are many potential situations, for example in the real estate area, where objective market values and a "market" test are difficult or impossible to measure. For this reason and to lessen the risk of conflicts that could be harmful to the bank or the public, consideration should be given to a prohibition on loans by a bank to any entity in which a bank affiliate has a substantial or controlling ownership interest. This would help assure that a bank's lending judgments would not be clouded by the equity relationship and would help maintain one of the basic public policy objectives of the Act -- the maintenance of impartiality in the credit extension process.

Controlling Excessive Risk

A basic question in appraising the Administration proposal is whether the result would be to increase unduly the risks to the stability of a bank, and to the banking system generally. As indicated earlier, we do not believe that the fortunes of a bank can be insulated effectively from other parts of its holding company subject to common management, notwithstanding adoption of formal rules and regulations to avoid conflicts of interest and to minimize appearance of a common entity. Consequently, we have reviewed the Administration proposal from that point of view, and we are satisfied that sufficient supervisory authority would be provided to deal with most sources of potential difficulty.

We remain concerned with the area of real estate investment and development, which are, by their very nature, subject to high risk. In recognition of those dangers, the proposed bill limits the investment a bank holding company can make in a real estate development subsidiary to not more than five percent of the primary capital of the holding company. We view this limit as a reasonable and necessary restraint on the size of the capital commitment a bank holding company may make in its real estate development subsidiary, but we also believe, at least in the early stages of bank involvement with this activity, that further restraints may be necessary. For example, a high degree of leveraging in relatively speculative or otherwise risky real estate development could effectively impair the intended effect of the limit. The experience with real estate investment trusts, when banks had no equity involvement but felt their name and reputation were at stake, remains relevant in assessing the nature of bank exposure to large ventures carried out by affiliated companies.

In that light, we believe it appropriate that the Congress clearly provide regulatory authority for the Federal Reserve to define more precisely the nature of permissible real estate development and the amount by which such a subsidiary could leverage its capital. We also raise the question of whether such activity should normally extend to active control and ownership of essentially commercial operations -- construction companies, building operations, land speculation, and the like. Our understanding is that many bank holding companies are primarily interested in opportunities for equity or equity-like participation in real estate projects under the active management and control of others and in fuller participation in the financing of such ventures. This range of activities is more congruent with the experience and role of financial institutions.

While similar questions have been raised about the risks involved in insurance underwriting, and particularly underwriting of property and casualty insurance, the record suggests that these risks can be effectively managed through application of prudent underwriting practices. Such subsidiaries would remain under the supervision of relevant state authorities. Thus, we do not suggest statutory limitations on the types of insurance underwriting that should be considered permissible. However, because of the potential risks involved in some kinds of property and casualty insurance, I welcome the flexibility provided by the proposed bill to limit the scope of insurance underwriting by bank holding companies if experience indicates a need ~~to~~ circumscribe the scope of banking organization participation in this activity.

Consideration of risk and potential concentration of financial resources coincide in suggesting another limitation similar to that imposed by the bill on real estate development companies would be appropriate. As a general proposition, bank holding companies could be expected to enter the insurance underwriting business through acquisitions of existing companies with management expertise in place and with seasoned portfolios rather than through de novo expansion. The same is also likely to be the case for insurance companies entering the banking business. The speed or degree to which these major industries, which have historically operated separately, should be permitted to combine within a holding company structure seems to us an important question. We have doubts about whether it would be good public policy to allow the largest banks to acquire the largest insurance companies, or conversely, the largest insurance companies to acquire the nation's largest banks.

At some point in the future, should experience confirm that combinations of insurance and banking firms have raised no special problems, elimination of all restraints on such amalgamations may be appropriate and desirable. For now, we would suggest that the process proceed at a more deliberate pace, and an effective means of accomplishing that would be to relate bank holding company investment in an insurance company to a limited fraction of its capital. Under such a rule, the largest banks would be able to purchase smaller or medium-sized underwriters; smaller banks would have to combine in joint ventures to accomplish this result -- not an undesirable result to assure spreading of risk and avoidance of relationships that could result in incentives for tying. Reciprocally, a holding company with a dominant large insurance company would be limited in the size of its bank acquisitions. The bill should be amended to provide explicit authority to apply such an approach as we gain experience.

To assure that the objectives I have outlined can be fully achieved it would be advisable to clarify the provisions of the Bank Holding Company Act to assure that the general examination and regulatory authority of the Board extend on the same basis to insurance underwriting subsidiaries of bank holding companies as to other nonbanking subsidiaries. The provisions of existing federal law delegate insurance regulation entirely to the states.

Competitive Equality Among Depository Institutions

I have reviewed with the Committee before our concern that as thrifts have assumed more and more commercial banking powers, and as they also retain powers that extend well beyond those of banks and bank holding companies, competition among depository institutions is distorted and inequitable. Left unattended, we are drifting into an inconsistent and irrational public policy. To the extent restrictions and regulations on bank holding companies are justified by abiding public concern, those restrictions will be undercut to the extent the same or similar banking powers can be exercised in a more liberal (or in this context "laxer") regulatory environment. To the extent the restrictions are not justified, they should be abolished.

To illustrate the potential in the present situation, firms engaged in any type of commercial or financial activity can potentially own a savings and loan association which, in turn, has powers comparable to banks but may also (1) branch or otherwise expand interstate and intra-state; (2) have insurance and real estate development subsidiaries; (3) receive long-term expansion funding from the Home Loan Banks; and (4) qualify for special bad debt tax treatment by the IRS. In practice, federally chartered thrifts still have limited commercial loan and demand deposit powers, and the Federal Home Loan Bank Board has not encouraged widespread ownership of thrifts by commercial firms or investment houses. But it is also true that some states have provided, at their own initiative, full banking powers and more to their own thrifts.

Under the Garn-St Germain Act, the exemption for the unitary savings and loan association holding company from the activity restrictions of the S&L Holding Company Act -- and therefore from restrictions on interstate activities and commercial ownership -- are lost if an association fails to qualify for the special bad debt deduction for tax purposes. However, it may be relatively easy to meet the required asset test and at the same time engage in a rather diversified range of banking activities. Our data show that the overwhelming majority of thrift institutions do qualify for the special treatment provided by law because they have in fact specialized in home mortgages. However, over time competitive opportunities provided by the existing rule will likely be increasingly utilized.

The Administration bill approaches these imbalances from two directions. The new powers provided to bank holding companies would, in important respects, match the powers currently available to thrift holding companies; at the same time, the special status afforded to unitary thrift holding companies would, prospectively, be eliminated and the scope of activities of thrift holding companies and service corporations would be the same as those of banking organizations. These provisions of the Treasury bill would not entirely eliminate the differences between thrift and bank organizations; thrifts would continue to have more favorable branching flexibility and tax treatment, and access to Home Loan Bank funds for expansion purposes.

Nonetheless, the proposal will inevitably be controversial, involving as it does a clear step toward more uniform regulatory treatment, however justified that may appear to be in view of the growing banking powers of thrifts. Such concern may be more justified among thrifts that in fact are not substantial competitors in traditional commercial banking markets and who wish to retain their special character in emphasizing residential mortgage lending.

I have on a number of occasions, before this Committee and elsewhere, noted my personal belief that specialized financial institutions have served this country well over time, and the Federal Reserve could be supportive of some differences in regulatory, tax, and other approaches related to institutions that in fact choose to remain specialized home lenders. For example, one could explore an approach that provides that, if a thrift institution or thrift holding company maintains most of its assets in residential mortgages (including mortgage-backed securities), such an institution would maintain most of the attributes of a unitary S&L holding company, its current tax status, full access to Federal Home Loan Bank financing, branching intra- and inter-state, and most service corporation powers. It might also be owned by a commercial company so long as the thrift operation was fully separated from the commercial interests and not operated in tandem and provided it could exercise no greater powers than presently authorized. We would not recommend interlocks with full scale investment banking houses because of the envisioned exposure to conflicts of interest and risk. As a matter of reference, about three quarters of all savings and loans currently have 65 percent or more of their assets in residential mortgages and mortgage-backed securities, and two-thirds have that percentage in 1-4 family mortgages and related securities. Any test of the requisite degree of "specialization", and related regulatory treatment, would also have to take account of the particular tradition of savings banks.

On the other hand, a thrift organization that of its own volition engaged in more diversified activities, including sizable amounts of commercial lending and other business relationships, should presumably have to forego the special provisions of law that are unavailable, as a matter of public policy, to banking organizations. We would, of course, envision that it would continue to be supervised by the FHLBB, as proposed in the Administration bill.

Such an approach, while needing refinement and closer examination, seems to me in keeping with the basic traditions of the thrift industry.

Federal-State Banking Authorities

The Administration bill does not deal with another difficult question -- the proper scope of authority of the federal and state governments in regulating the nonbanking activities of banks. The problem arises from some recent state actions authorizing vastly enlarged powers for banks and their subsidiaries that are inconsistent with the comprehensive framework established by Congress for regulating the conduct of nonbank activities by banking organizations.

The conflicting approaches are of recent origin. For many years, the parallel systems -- federal regulation of nonbanking activities through the Bank Holding Company Act and dual state-federal regulation of banking activities -- have worked tolerably well together; they afforded an element of useful experimentation and local adaptation so long as basic goals and approaches were commonly shared. In this context, the Board has facilitated the freedom of action for state authorities by adopting a rule that a bank holding company may conduct through a subsidiary any activity that a state bank could perform directly; in practice, state authorized powers for banks did not go far beyond those permitted for nonbank subsidiaries by federal law. Our recent survey of the nonbank powers of banks under state law indicates that the great majority of states have remained conservative in their authorization of bank powers and have not gone beyond those provided in the Bank Holding Company Act.

Now, however, major inconsistencies have arisen between federal and state law because some -- so far very few -- of the states have authorized bank and thrift powers that are actually or potentially in sharp conflict with the framework of powers for banking organizations established by Congress. The Board is concerned that competition in financial markets, and competition between states for economic development, is in effect producing competition to establish a lax regulatory framework for banking organizations without taking account of the national issues at stake, and at the clear risk of undermining prudential standards.

Although I regret the need to take a step which would limit the freedom of action of states, it seems plain that the safety and soundness of the banking system is, in the end, a matter of national interest. The recent tendency of some states to act in a manner out of keeping with national concerns requires a response.

Specifically, institutions, whether federally or state chartered, that are full beneficiaries of the federal banking safety net should be subject to the minimum federal rules established because of the overriding national interest in safe and sound banks. What appears necessary is a provision in the new legislation setting some limits with respect to the ability of states to provide authority for a state-chartered institution to pursue activities within such an institution beyond the powers permitted to depository institutions and their holding companies under federal law. The moratorium bill that the Board has proposed also includes such a provision.

States, for instance, might experiment, as they have in the past, in areas that do not pose fundamental questions of safety and soundness and that are largely local in character. Moreover, states might be permitted discretion to authorize any banking and nonbanking activities for state-chartered institutions or their subsidiaries that they deem to be desirable, provided that these activities may be performed only for customers resident in the authorizing state. Such arrangements would preserve local initiative, while assuring that interstate commerce was conducted within the framework for a safe and sound banking system that the Congress decides is most appropriate for the country as a whole.

Interstate Banking

The Administration bill does also not address another major question facing the American financial system -- the appropriate geographic limits for banking operations.

Despite the Douglas Amendment and the McFadden Act, we now have, de facto, a large measure of interstate banking in some product areas. Through more than 7,000 interstate offices, some large banking organizations today are conducting interstate operations through a variety of avenues, including Edge Act subsidiaries, loan production offices, credit card operations, grandfathered holding companies, interstate acquisition of failing banks and thrifts, and a number of activities "closely related to banking" allowed under the Bank Holding Company Act -- mortgage banking, personal loan companies, and others. And no counting of offices can illustrate the further penetration of interstate markets for deposits and loans made possible by the speed and economy of modern data processing, communications, and transportation.

But these developments are uneven and haphazard. In prohibiting brick and mortar presence across state lines for an ordinary range of personal banking services, present law forces banking services to be fragmented, even within many metropolitan areas, whether viewed from the perspective of the banking organization or its customers. The end result is that risks may be increased, costs are higher than necessary making competition less effective from the customer's perspective, and particular banking institutions are relatively advantaged or disadvantaged. To take one example of obvious anomalies, deposits can be and are now brokered across the country, with securities dealers and others acting as intermediaries through a network of local offices. But banks themselves cannot attract those deposits directly from local offices beyond their own state.

It is not surprising that the states themselves have begun to recognize the anomalies and have started to relax some of the restrictions allowed by the McFadden Act and Douglas Amendment. Four states have authorized interstate banking at least on a reciprocal basis; three New England states are authorizing regional, reciprocal entry; four other states have authorized out-of-state entry for some form of limited banking, such as credit card or wholesale banking operations; and four states permit entry by certain grandfathered companies.

These state actions are constructive in breaking down outmoded barriers but they also dramatically illustrate the haphazard and unequal development of interstate activity. A closely integrated economy requires and deserves more uniform rules in this important area. It is reasonable to ask whether rules that prohibit New York or St. Louis banking organizations from establishing offices across a river, but would permit them to sell insurance in Arizona, serves a national purpose. Similar doubts arise about the logic of proposals that a Providence, Rhode Island bank be able to purchase a bank two states and 150 miles away in southern Vermont, but that an Albany, New York bank 30 miles away be prohibited. We also have the anomaly of states welcoming foreign banks within their borders, while prohibiting entry of U.S. banks from neighboring states.

For want of any better rule to assure gradualism and to take state preferences into account in the evolution of interstate banking, regional compacts have had an appeal to some as a transitional device. We are concerned, however, about the implications for a kind of balkanization of the process that could discriminate against banking organizations in some states and, without serving a legitimate local purpose, limit the ability of banks wishing to sell or merge to find an appropriate partner. These concerns are already reflected in litigation that has been brought by interested parties to challenge the constitutionality of regional arrangements. I also have, for these reasons, reservations about the legislation proposed to provide authority in federal law for such arrangements in New England.

I have another concern about the impact of the rules prohibiting interstate banking. There is a natural tendency by those who are shut off from their natural avenues of expansion to divert entreprenurial energies into other areas open to them. Undue restrictions on interstate banking in effect create an artificial incentive for banks to enter into nonbanking fields of activity. Over time the tendency would be to diminish the relative importance of the bank, and management attention given the bank, within a holding company structure ultimately weakening the safety and soundness of the banking system itself.

At the same time, I recognize the traditional and historic concern about local control of banking, the importance of healthy community banks, and the dangers from excessive concentration of resources. Fortunately, we have a good deal of experience within large states about the ability of small banks to survive and prosper alongside relative giants -- and for the good reason that they can operate efficiently and establish solid relations with local consumers and businesses. Over time, interstate banking would inevitably mean fewer banks and larger average size, but properly implemented and controlled I see no danger that the United States would be bereft of large numbers of smaller banks, or that, with appropriate safeguards, excessive concentration would become a problem.

There are a variety of possibilities for transitional and more permanent arrangements to help assure constructive results. For example, interstate banking might, at least initially, be confined to establishing separate legal entities in other states as part of a multi-bank holding company that would have to conform to state branching restrictions and to state law and supervision in other respects.

Similarly, there are a number of steps that can be taken to prevent excessive concentration of banking resources, to limit the ability of the largest banks to join together, to define the share of resources in a state or area that would be controlled by a single organization, as well as by other means.

In sum, a solution that accommodates the forces of technology and competition, while taking account of our public policy objectives of avoiding concentration of resources and maintaining a role for the states in regulating banking in their jurisdictions, is necessary. There have been numerous studies and recommendations over the years with regard to the proper balancing of federal and state interests in the geographic scope for banking operations.

What is necessary now is to find a consensus on a particular approach. We would be glad to assist your deliberations by providing, in more specific terms, a variety of approaches to balance the various considerations, and by working with other banking agencies and other groups to that end.

Interest on Demand Deposits and Reserves

Comments have also been requested on two additional issues of significance for monetary policy and competition among financial institutions. These issues concern the federal prohibition against the payment of interest on demand deposits and the payment of interest on reserve balances held by depository institutions with the Federal Reserve System.

As you know, the Depository Institutions Deregulation Committee recently recommended that depository institutions be permitted to pay interest on demand deposits. In approaching this question, it should be recognized that developments over a number of years have importantly undermined both the effectiveness and rationale of the prohibitions. These developments include (1) implicit interest payments on demand deposits through the provision of customer services without explicit charge or at fees below cost, (2) legislative and regulatory changes to permit explicit interest-bearing transaction accounts for non-business customers that are legally distinct from demand deposits, although functionally the same, and (3) market development of close demand deposit substitutes that earn interest, such as money market mutual funds.

The cost implications for depository institutions as a result of authorizing the payment of interest on demand deposits should be manageable over time precisely because many transaction balances are already, directly or indirectly, earning a market rate of return. The material submitted to the Committee by Secretary Regan on behalf of the DIDC on this point is consistent with our analysis.

The potential adverse earnings impact of interest-bearing demand deposits could be mitigated by requiring the payment of interest on required reserve balances held with the Federal Reserve Banks. As a general matter, the Board believes that the payment of a market-related interest rate on reserve balances would be desirable in light of both equity and monetary policy considerations.

Reserve requirements, while imposed for monetary policy purposes, also, from the viewpoint of the depository institution, represent a form of tax that falls unevenly across institutions providing comparable services. Interest on required reserves would remove this competitive distortion. In addition, such payments would work to discourage the incentives toward the development of transaction-type accounts outside the depository system, thus protecting the ability of the Federal Reserve to carry out monetary policy efficiently over time and tending to maintain the payments system within the basic framework of regulated depository institutions and the federal "safety net."

At the same time, payment of explicit interest on demand deposits and reserve balances should be consistent with general considerations of efficiency in the allocation of economic resources and effective competition. Consequently, the Board supports action along these lines.

More specifically, bills have been introduced with the intent of requiring interest to be paid on a limited fraction of required reserves -- those held against money market deposit accounts and Super NOW accounts -- accounts upon which depository institutions now pay market rates of interest. (Most MMDA's -- those not held by businesses -- have no reserve requirement.) Paying interest on reserve balances held against Super NOW accounts would remove one cost for depository institutions not borne by money market fund or other providers of a similar service and then tend to further equalize competitive opportunities. For a period of time, interpretation of the monetary aggregates, particularly M1, could be further complicated by causing savings funds now held in MMDA's or other forms to shift into Super NOW accounts, which is a component of M1. With interest paid on reserve balances, depositors would be able to receive as good a yield on Super NOW accounts as on MMDA's (taking into account service charges) and the former would also have the capacity for unlimited transfers by check. (Potential shifts of this kind could, of course, also be large if market interest rates are to be permitted on demand deposits.) However, that adverse effect is not, in our judgment, a compelling reason not to adopt the proposal, particularly in circumstances in which it could be viewed as a transitional step toward payment of interest on demand deposits and related reserve balances.

Other things equal, paying interest on reserve balances generally would involve a drain on Treasury revenues. Thus, while the Board, as a matter of principle, favors payment of interest on all reserve balances, the question remains of an appropriate phase-in. This is, of course, inevitably related to the present budgetary position, but we do not believe that, over time, reserve requirements should be looked upon as a revenue measure. If banks and other depository institutions are to be specially taxed, such a decision should be made explicitly on grounds other than as a by-product of the role of reserve requirements as an instrument of monetary policy. Payment of interest only on reserves against Super NOW accounts and non-personal MMDA's, at present interest rates, is estimated to entail a net revenue loss of $125 million a year initially, and the figure would rise over time as deregulation proceeds and these deposit forms become more important.

We believe that such a decision should imply a transition toward payment of interest on reserves more generally to avoid distortions among various types of transaction accounts. In that case, the costs would, of course, be substantially larger.

Finally, I would like to address a related point and remind the Committee of the long-standing Board view that authority should be provided to apply reserve requirements to institutions that are not formally depository institutions (and thus are not covered by the prudential rules applicable to these institutions and their holding companies) but that do offer transaction accounts similar to those offered by banks. As long as these close substitutes for bank deposits are free from reserve requirements, they have a potential competitive advantage relative to bank deposits and, at times, they can complicate the task of conducting monetary policy.

In an environment in which Regulation Q ceilings on deposits have been largely eliminated, such problems may not be as acute as they were in the 1981-82 period. Payment of interest on reserves would, as indicated, remove a remaining source of competitive distortion. At the same time, however, the process of financial innovation could well produce still other instruments which will present new problems.

Thus, the Board believes it would be prudent to incorporate into the bill a provision whereby financial instruments issued by nonbank institutions that have transaction or third-party payment powers would be subject to reserve requirements. The Board would not expect to use this authority unless conditions arose to demonstrate its necessity.

MORATORIUM USED AS A DELAY TACTIC

The **Chairman**. Thank you, Mr. Chairman. At the beginning of your statement you once again stated your support of a moratorium. I have consistently opposed a moratorium on the basis that in my 9 years in the Senate it has always been used as a delay tactic. It is always supported on the basis that things are changing very rapidly. The arguments don't change. The issues do, but we have got to do something about it, and we are not willing to face up to those issues and make decisions.

Your bill, which I introduced on request, would provide for a moratorium ending December 31. First of all, we are not in session on December 31, at least I hope we will not be. We sometimes get close to that, and we don't usually come back in until the 20th or so, and you start the legislative process over again.

So automatically, I could guarantee you a 90-day extension of that moratorium, more likely 6 months, and so we are into July of next year. I sense the feeling within the Congress—you have said these in the end of your statement—how controversial many of these issues are, and they are.

That's why a moratorium is basically supported, because it just pushes it down the road. It's the greatest legislative tactic that is ever used around here. Put it off to the future and hope something will happen, it will go away, I can pull the covers over my head. What will a moratorium accomplish other than delay? You know and I know that if we impose a moratorium, it would be impossible for me to push this committee or this Congress to take any action during that period of time, and we would be right back where we were today, with all of the issues very well known, just as controversial as can be, with all the different trade associations, with their opposing positions, and all we would have done was had a delay during that period of time.

I would much prefer to have you push Congress to say look, the issues are well known, they have been around for a good deal of time. It's just as easy to face up with them now in September or October as it would be next July. Except you have said freeze the world, let's not do anything.

I remember the same type of advice in December of 1981. Not just from you alone, but all of the regulators came to see me, en masse, in my office, and said, good heavens, Jake, you can't do this, you can't push for this overall bill, you have just got to do this emergency piece of legislation, the regulators bill, and the capital infusion. If I had listened to that advice at that time—collective advice from all of the good wise people around town—there would have been no changes as appeared in Garn-St Germain, they wouldn't have existed.

So I see the same scenario happening over again. It happened a long time before you were Chairman of the Fed. It happened before I was chairman of this committee. Moratorium is the easy copout rather than facing the issues. What is different now than any other time that moratoriums have been proposed?

Mr. **Volcker**. I obviously look upon it somewhat differently. I don't know the whole history of moratoriums. If you tell me you can deal with these issues, and that there is a reasonable prospect that you can get a bill out— a comprehensive bill—and get it passed in this session, I won't be worried about the moratorium. But you expressed some doubt about that yourself, I think, in your early statement.

The CHAIRMAN. I have great doubt about that. But my point is simply, if we proceed during the moratorium—but we won't. So we will be back in the same position next July.

Mr. VOLCKER. That's a difference in judgment. You suggest a possibility—that I would not like to see. I think a more realistic date for termination of a moratorium might be around April 30, which would give you a feasible time period.

The other side of the coin is that the world is not standing still; matters are proceeding in a way that I think prejudices your discussions. There's always a reluctance to reverse actions that have already been taken in the marketplace that affect actual investments, especially when things are moving very rapidly.

There are things going on that are quite outside the range of the Treasury bill, broad as that is. They further complicate, it seems to me, your legislative task. Every few months, States are providing new powers that are beyond anything in the range of the legislation you are considering.

It's going to be harder to reverse that if some warning shot, so to speak, is not fired, indicating that you have these things under active consideration and that you are going to insist, in the end, that your judgment about broad national policies in these areas is going to prevail. Your opportunity to make that judgment is undercut with every passing month, in my judgment, as the de facto situation changes.

I don't want to delay this process at all. I would like to see it take place just as rapidly as possible, and I don't see why we could not have constructive legislation, let's say in a 6-month period.

Not every detail is laid out in this bill. But a positive piece of legislation could be worked out in that time period, without having your options further curtailed by what is going on in the market. I would note that most of the basic legislative proposals, including the Treasury proposal, pick up elements that would already be incorporated in the moratorium; that would give you a large head start on the legislation. A moratorium freezes things. It also begins to redefine what's a bank and what is not a bank in precisely the way that is proposed in the Treasury bill and in other prospective pieces of legislation, so I don't see the actions as inconsistent at all and, indeed, I would think a moratorium would facilitate your efforts, but that's a difference in perspective.

The CHAIRMAN. Mr. Chairman, I don't disagree with you. Everybody in this room has heard me talk about the revolution in the financial services industry, and how rapidly over the last few years the change has been occurring. There's no doubt about that. My point is, because of that change, is there not more pressure to make some of these decisions, than if there is a moratorium. I know this side, the legislative side. The minute a moratorium is enacted, the interest in doing something is going to go away until the end of that moratorium, and then the likelihood is just extend the moratorium.

Mr. **Volcker**. My answer to that is yes and no. It depends on how people are affected by the moratorium. Obviously, if they feel protected by a moratorium, some people will find the urgency for change reduced. Other people who want to undertake certain new activities are going to be unhappy about the moratorium.

The moratorium has some core that I think many people believe should be part of any permanent legislation. It also has an element of artificiality in holding things in place. It depends on how particular parties are affected, whether it takes the pressure off or puts it on.

I don't think it's quite as unambiguous as you suggest; some people would want to get on, even more urgently, in order to have a larger scope of powers defined and not be frozen until that happened.

The **Chairman**. Let's go back to December of 1981 again. What do you think the situation would be today, if I had yielded to the pressure, simply accepted those two emergency pieces of legislation. One of them that sunsetted in September of 1982, a year ago, would have sunsetted, and the advice was that it would be on my shoulders and 1,000 S&L's might fail; it was all lumped on me to do that. Now I am hearing all of these changes are going to occur unless we just freeze--when do we make policy decisions rather than just simply taking the easy way out?

Mr. **Volcker**. I want you to make a policy decision just as quickly as you can make it.

The **Chairman**. But the fact that you continue to press for a moratorium, delays any possibility of getting decisions on the policy issues in a reasonable amount of time.

Mr. **Volcker**. I don't believe so, and I hope not. You apparently have a different view of that, but I just want to record that I differ.

The **Chairman**. Only from watching 9 years of moratoriums.

Mr. **Volcker**. With that earlier legislation, I think you had a coalescence of forces late in the day, after a lot of discussion of pieces of that bill that didn't have much to do with that emergency legislation; that, I suspect, would have come together or not come together whether or not the emergency package had been enacted or not. The discussion had to do with the bidding instrument, as you recall, and the balance of advantages and disadvantages that people saw in that against the powers provisions. The emergency provisions were never in much controversy.

The **Chairman**. They were not in any controversy.

Mr. **Volcker**. We regulators wanted it.

The **Chairman**. Had they been separated out, Mr. Chairman, I will guarantee you, as strongly as I can possibly say, that there never would have been the other titles passed. The pressure to get the emergency pieces of legislation carried most other parts of that bill that could have easily been delayed. There is no doubt about that in my mind.

Mr. **Volcker**. I don't believe the moratorium would relieve pressures. It has a lot of support, as you know, by some industry people; it has a lot of opposition by others. Those that oppose it would presumably have a great interest in keeping the pressure on.

The **Chairman**. Most people who favor the moratorium have some built-in advantage with the status quo, therefore they don't want change, and most of them are those that oppose policy changes. They like the status quo, so freeze it.

Mr. **VOLCKER**. My judgment is that without a moratorium the people most at jeopardy are the established banking organizations. They are the ones that are prejudiced by the existing situation, where other organizations can increasingly do banking business in an absence of rules that the banks have to follow.

It's unfair, and it's going to put you in an increasingly prejudiced position the longer it goes on. I think that's the case for moratorium.

The **CHAIRMAN**. My time is up on this round.

Senator Proxmire?

Senator **PROXMIRE**. Thank you, Mr. Chairman.

MORATORIUM WOULD STOP ENCROACHMENT OF NONBANKING INSTITUTIONS

Chairman Volcker, as I understand it, what the moratorium would accomplish would be to stop the encroachment of nonbanking institutions into banking and of banks into areas which the Congress may or may not decide they should go into. The moratorium bill closes the nonbank bank loophole, but it would not be strictly a status quo. It would stop action until the Congress could act.

It would also prevent the States from allowing State banks to expand activities into not authorized under the Bank Holding Act. So that the moratorium, as I understand it, does not simply avoid action; it would actually change the basic law, would it not?

Mr. **VOLCKER**. I think the moratorium would permit——

Senator **PROXMIRE**. As you propose it.

Mr. **VOLCKER** [continuing]. Would permit banking organizations to engage in all those activities and new activities within the framework of existing law.

It is designed, basically, to deal with those situations where nonbanking organizations are moving into the banking business in a way that we think was not contemplated and is contrary to the spirit, if not the letter, of the current law, but that is possible because of the peculiarities of the definition of banks. It would also, as you indicated, curtail the ability of States to authorize a broad expansion of banking services beyond that permitted by Federal law.

Senator **PROXMIRE**. Now as I understand it, what you have told us is that you would be perfectly willing to have us move on the Treasury bill instead——

Mr. **VOLCKER**. Yes.

Senator **PROXMIRE**. If we can do that in the same time, that's fine.

Mr. **VOLCKER**. If you can pass the Treasury bill right away with whatever changes are made, there's no need for a moratorium.

CONSEQUENCES OF NO CONGRESSIONAL ACTION

Senator **PROXMIRE**. What are the consequences if we don't act on either one: if we don't pass the moratorium and we don't act on the Treasury bill in this session of Congress?

Mr. VOLCKER. These are two obvious consequences as the ingenuity of lawyers is further exercised. You are going to have nonbanking organizations, commercial firms—Sears, Roebuck—buying nonbank banks or thrifts and engaging in a banking business in tandem with their own operations in ways that have been against public policy for years and years. You are going to have interlocks of investment companies and banks and thrifts. You have that going on now. You have Glass-Steagall on the books, and you never made any policy decision to reverse Glass-Steagall, but it's being undercut every month through the use of these loopholes.

You will continue to have a pattern, I suppose, of State A thinking that if its sister State B provides broad powers—not through any concept of what an appropriate banking system is, but because some bank will move employment out of State A into State B—so then State A better do something to get the employment back again. State A will change its banking laws, as a matter of State economic development. If that's the way you want to see the banking laws in the country evolve, that's one thing, but that's not my vision of the way the banking laws should evolve.

Senator PROXMIRE. I agree with you; I wouldn't like to see it, but explain to me why, from your standpoint, would it be a bad public policy to have Sears, Roebuck in the banking business? Let me put it this way. It's been sometimes argued that all of the changes taking place in the financial services industry are in response to the demands of consumers that these services be combined into one organization.

Do you share that perspective on how much the revolution in banking in the last year or two has been driven by consumer demand?

POTENTIAL CONFLICT OF INTEREST

Mr. VOLCKER. Sears, Roebuck, to take that example, is not only in the banking business; it is in the investment business. It is still in an early stage of evolution, but it goes to all these activities. I think this goes back to some fundamental, almost philosophic, questions that Congress has to deal with. I think our banking system is based upon a tradition that some broad separation of banking and commerce is desirable because of the potential for conflict of interest in that relationship.

If you have a direct tie between a bank and a commercial firm, what does that do to the impartiality of the credit-granting process throughout the country? Do banks give favoritism to their sister companies? Do they discriminate their credit-granting process against the competitors of the company in which they have an interest? What risk does that give rise to if the credit-granting process is biased by the interests of other parts of the holding company?

I think these are the traditional concerns underlying American traditions in this area, together with some feeling about the concentration of resources.

You have, at the extreme, the zaibatsu tradition in Japan where you have great conglomerations of financial institutions, banks, and commercial enterprises, operating as a more or less cohesive whole. Is that good social policy as well as economic policy for the United States? That's the kind of question you have to deal with.

LIFTING CURRENT RESTRICTIONS ON INTERSTATE BANKING

Senator **Proxmire**. Chairman Volcker, one part of your testimony gives me considerable pause—and I think it might shake up some of the small communities and maybe banks in those communities. On pages 28 through 33 of your testimony, you suggest that current restrictions on interstate banking in the Douglas amendment and McFadden Act be lifted. You say on page 33, and I quote: "There are a number of steps that can be taken to prevent excessive concentration of banking resources—" including defining the share of resources in a State or area that would be controlled by a single organization.

Now, former Governor Coldwell on June 29, suggested, and I quote: "It does not seem unreasonable to suggest that banking organizations with 5 percent of the Nation's domestic deposits be prohibited from further acquisition." Do you agree with that?

Mr. **Volcker**. There are a lot of different ways you could do it. You could take some limitation of that sort. You can put in rules that say the largest banks in the country, according to some ranking, could not combine with one another, or that their acquisitions would have to be confined to institutions below a certain size. There are a variety of devices of that sort that I think would be effective in preventing excessive concentration. Where you draw those lines——

Senator **Proxmire**. How about the 5 percent, is that a reasonable number?

Mr. **Volcker**. Five percent is a pretty big bank at this stage. I hesitate about saying no acquisition of any size—that may be a little sweeping. You might say that those banks could limit the size of their acquisitions over a period of time.

Senator **Proxmire**. Would you agree that it might be useful to provide that any bank with more than 20 percent of the deposits in a given State be prohibited from expanding by merger, but such a bank could still expand by de novo branching?

Mr. **Volcker**. That kind of thing is another possibility. That's precisely the kind of thing I had in mind in saying you could put together a combination of these approaches that would provide ample protection against undue concentration and protection of competition. I don't want to make a final judgment this morning on any of these, but we could test a lot of those propositions for you and see how they look in practice, if you desire.

CONSOLIDATION OF BANK REGULATIONS

Senator **Proxmire**. Now you spoke about having an adequate supervisory framework for this whole operation. Just yesterday, the New York Times reported that the Bush task force is about to recommend the consolidation of bank regulation. It's pretty drastic consolidation and quite controversial. It would knock out the Comptroller of the Currency, it would take away from the Federal Reserve Board all regulatory authority except supervision of the 18 or 20 biggest banks in the country, and it would create a Federal community bank board which would, I guess, regulate smaller banks.

Is this the kind of thing you have in mind, and should we move ahead before we have that framework in place?

Mr. VOLCKER. Let me first of all say that I am a member of that task force, and I don't think it has met for 4 or 5 months. I think any indication of what it is going to propose, is, from my viewpoint, premature. I have no direct knowledge.

Senator PROXMIRE. You know how these staffs operate.

Mr. VOLCKER. It apparently has an active staff. I don't know how widespread those feelings are.

To address your particular question, what I meant by saying an adequate supervisory framework is provided in this bill is the oversight the Federal Reserve would have over the holding company. I am looking at it in the context of this bill, that some regulatory agency—the Federal Reserve in this bill—has that oversight.

The question of the locus of banking supervision is going to be addressed, by the Bush task force, and presumably will be addressed by the Congress. I do not think this effort in any way has to be held up pending that reexamination. In fact, I would think quite the opposite; that to look at the logic of banking supervision and regulation, and the locus thereof, we have to have some idea of what we are talking about in terms of powers and structure. This bill itself doesn't leave any loopholes, doesn't leave any discontinuities, because the current Federal Reserve role regarding holding companies would not be changed. The whole supervisory process would be greatly streamlined—maybe liberalized is the right word—but you have an agency in place, functioning, and I don't think there's any danger of any lapse. Then, having settled on the basic structural characteristics of the banking system, I think it's perfectly logical to go back and look at who does the supervision and the way it's done.

Another major issue that's sitting out there is deposit insurance. There's a certain amount of concern about whether the precise nature of the way we operate the deposit insurance system is in the best interests of banking and the country and so forth. I think that is an important issue, but I think it's separable enough from this issue so that it could be dealt with after you deal with these basic structural problems.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Mr. Chairman, has the Federal Reserve Board taken a position on the legislation mandating interest be paid on sterile reserves of banks held with the Federal Reserve System? You made a comment that you're moving in that direction, but——

Mr. VOLCKER. On the stockholdings of the Federal Reserve by its member banks?

Senator MATTINGLY. Yes.

Mr. VOLCKER. We have in the past. That issue has not been active recently. There is a limitation on that stock dividend of 6 percent, which is not an attractive dividend in today's market. In the past—I don't remember whether as an official position or not—

we have suggested some flexibility in that area would be appropriate, so that it's not costly to hold Federal Reserve stock.

Senator MATTINGLY. How about interest on reserves?

Mr. VOLCKER. Interest on reserves I addressed in this statement; in principle, we favor that.

Senator MATTINGLY. Do you know what the cost would be?

Mr. VOLCKER. Yes; I have some estimates, but it depends on precisely what you do. There is a proposal currently to pay interest—presumably starting soon—on reserves held against money market deposit accounts, basically business money market deposit accounts, and super NOW accounts; we have estimated, at today's interest rates, if that took effect immediately, the net cost in terms of Treasury revenues would be about $125 million per year. It would get larger over time. If you immediately paid the full market rate on all required reserves, the net cost would be over $1 billion.

Senator MATTINGLY. Over $1 billion? And does that also increase as the years——

The CHAIRMAN. Would the Senator yield for just a point here?

Senator MATTINGLY. Yes.

The CHAIRMAN. Several years ago, Senator Tower and I proposed that this take place, that interest be paid on reserves. At that time the cost was estimated, depending on who is doing the estimate, from $500 million to $750 million.

Also, at that time, the Fed was returning to the Treasury $9 billion to $10 billion a year. Now I understand it's approximately $15 billion.

Mr. VOLCKER. Correct.

The CHAIRMAN. I think that defeats the whole purpose of the Federal Reserve. It was intended to be self-sustaining, but it's the greatest profitmaker the Federal Government has. Over and above its operating expenses, it will return $15 billion to the Treasury. I don't think any of these numbers, whatever estimate is used, is an over-large amount to remove those sterile reserves. It is a tax, as the Chairman indicated, an indirect tax. I personally favor, have done for years, payment of interest on reserves, but I think we have to put the cost of payment of interest on those reserves at the tremendous profit the Fed produces. It has increased by about $5 billion just since we offered that amendment a few years ago.

Senator MATTINGLY. Thank you for your comment. The only other entity that probably makes that much money annually is the IRS.

The CHAIRMAN. But the IRS steals it.

Senator MATTINGLY. We are all aware of the abuses that existed in the financial arena in the 1930's, of course, which prompted congressional enactment of the Glass-Steagall Act. Do you believe that S. 1609 would safeguard against a recurrence of such abuses?

Mr. VOLCKER. S. 1609 is the Treasury bill?

Senator MATTINGLY. No; it's not the Treasury bill. I didn't say that. I said, would S. 1609 safeguard against a recurrence of such abuses?

Mr. VOLCKER. I just want to make sure what S. 1609——

Senator MATTINGLY. Yes; excuse me.

Mr. VOLCKER. That is the basic administration proposal.

Senator MATTINGLY. Not the moratorium proposal.

ADVANTAGES OF BANKS WITH SEPARATE SUBSIDIARIES

Mr. **Volcker**. It does provide safeguards. For one thing, it does not permit underwriting of corporate securities, either debt or equity. That is where you would expect the major problems to arise. It does extend the ability of bank holding companies to underwrite municipal revenue bonds; many banks have underwritten municipal general obligation bonds. We do not see that that importantly increases the risk of abuse in any way.

The extension into the mutual fund area, for instance, has raised questions historically; it raises questions currently. If your question is whether it's adequately dealt with in the Treasury bill, I think our answer is, broadly, yes. The mutual fund industry itself has proposed some further safeguards; I think some of those deserve a hearing, but there can be adequate protection, yes.

Senator **Mattingly**. Would you elaborate a little on the degree of risk involved in allowing banks to underwrite municipal revenue bonds and dealing in mutual funds through a separate subsidiary of a holding company? In other words, by using a separate subsidiary approach, would the banks be 100 percent isolated against potential losses?

Mr. **Volcker**. No; we do not believe in the theory that simply putting something in a separate subsidiary isolates the bank 100 percent. Our experience is quite to the contrary. It's part of a common organization; every part of the organization is going to suffer or benefit from the condition of other parts of the organization.

I think that's particularly true with respect to a bank, where so much depends on confidence and continuity and trust and faith in management; I don't think you can completely isolate an activity by putting it in a subsidiary; but it helps, and it may be convenient.

To answer your question directly, banks have been underwriting—within the bank itself—general obligation municipal bonds, and I am not aware of any particular problems or abuses that have arisen in that area. I think those possibilities would be increased, perhaps to a small degree, to the extent that revenue bonds may in some cases provide more risk than general obligations bonds, but that's not even generally true.

It's not true, in general, that revenue bonds are riskier than general obligations. The problems with conflicts of interest are minimized by the fact that these are public bodies, as general obligations, of course, are—I think those are containable. To the extent the risk are moderated by putting the function in a separate subsidiary, you have a further advantage. Mutual funds, can also be managed, but I do think it's worth looking at some of the particular proposals that were made by the mutual fund industry to further minimize any possibility of abuse in either direction.

Senator **Mattingly**. A lot of people in the insurance industry contend that allowing banks to engage in expanded insurance activities would result in abuses, such as tie-ins and related anticompetitive action on the part of the financial institutions.

Mr. **Volcker**. Right.

Senator MATTINGLY. Do you think S. 1609 addresses any of these issues?

Mr. VOLCKER. It addresses them at least indirectly, as I indicated in my comments initially. The bill does not touch the present provision of law which says that the commercial bank unit of a holding company itself could not engage in tying. Assuming that that's not changed, the present law would mean that there could not be tie-ins between extensions of credit by the commercial bank and, let's say, insurance brokerage or real estate brokerage.

One element of concern there—and I think legitimate concern—is dealt with by not disturbing the existing law. Whether further strengthening is necessary is something I think you want to look at. I, specifically, raise the question as to whether, as a matter of public policy, you would want to deal with potential tying, let's say, between a real estate brokerage arm of the holding company and an insurance brokerage arm of the holding company. At this stage, we are inclined to think it would not be necessary, that there would be tying, that there would be discounts provided by some institutions, but they already are by other types of institutions in those businesses.

Senator MATTINGLY. Do you feel the current law is satisfactory?

Mr. VOLCKER. Basically, yes.

Senator MATTINGLY. In other words, the current S. 1609 is too indirect a type of approach?

Mr. VOLCKER. Present law would continue under the S. 1609 proposal, and we broadly think of that as satisfactory. But it is an area that deserves a close look.

Senator MATTINGLY. In other words, you don't really think it complements existing law.

Mr. VOLCKER. It does strengthen existing law in providing—let me get the legal term right—a private right of action for trade groups. The trade group could enter in and contest an alleged tying practice, so, of course, that helps the enforcement of the concept in existing law.

Senator MATTINGLY. Let me go back to the prior question, when we were talking about the separate subsidiaries requirement. If the separate subsidiary doesn't isolate the bank 100 percent, should the expanded powers be allowed in the bank?

Mr. VOLCKER. I think there are, in most of these cases, reasons to put it in a separate subsidiary, and that does, to some degree, help on the isolation question. I don't think you are going to get anything like complete isolation, but you are better off having a separate subsidiary; it's easier to deal with conflicts and other problems if the activity is in a separate subsidiary.

Senator MATTINGLY. If you require a separate subsidiary, wouldn't it be pretty costly?

Mr. VOLCKER. I know many banks are reluctant to take their present municipal bond underwriting, which is right within the bank, and their government bond dealing, and put these in a separate subsidiary. We have lived with the arrangement historically of this not being in a separate subsidiary. If that's all that was being done, I see no point in putting it in a separate subsidiary. It's satisfactory where it is.

But this is part of a larger concept. I do agree that when you are talking about a large expansion in the powers of the holding company—into the insurance area, into real estate development, into insurance brokerage, into real estate brokerage—it does make good sense to put these in a separate subsidiary.

Among other reasons, some of those entities would be regulated separately. The insurance arm would be regulated by State insurance authorities. The investment company would be regulated by the SEC and should be. This kind of functional regulation becomes easier if the activity is in a separate subsidiary, and I think there are a variety of reasons for putting most of these activities in a separate subsidiary.

Senator **Mattingly**. My time is expired. I have some additional questions I would like to submit for the record.

[Response to written questions from committee members can be found on p. 202.]

The **Chairman**. Senator Dixon.

SMALL BANKS AND INTERSTATE BANKING

Senator **Dixon**. Mr. Volcker, you kind of hit me where I live on page 30 of your remarks, where you stated in connection with interstate banking questions, and I quote:

> It is reasonable to ask whether rules that prohibit New York or St. Louis banking organizations from establishing offices across a river, but would permit them to sell insurance in Arizona, serves a national purpose.

My home town is Belleville, Ill., 20 minutes from St. Louis to Busch Stadium to see a Cardinals ball game. When I went to the Illinois House of Representatives in 1950, the biggest issue in the General Assembly was the question of branch banking. I thought I would outgrow that when I came to the U.S. Senate.

The greatest issue in the Illinois Legislature in 1983 is still branch banking over three decades later, and I guess the big issue in this session of the Senate, at least in the Banking Committee, is going to be the question of interstate banking.

If I might pursue this just a moment further, the issue always was—and, of course, I have no beef against the great Chicago banks; they are fine banks and fine institutions—the issue always was, ought they to have all the banks in DuPage and Lake and Kane and Will Counties—ought they have to have all the country banks in northern Illinois and ought the St. Louis banks like Mercantile and Boatman's and others have all the banks in southern Illinois—and the populist issue, I guess, that's central to that whole question of ought we to have a number of great big banks in the United States of America rendering banking services to the whole Nation, or ought we to have a little bank in Freeburg, and a little bank in Millstock and places like that that deal with the little folks, the farmer, the small merchant on Main Street and folks like that all over America. I would like to know whether you as Chairman of the Fed and your associates have thought about that central issue.

Mr. **Volcker**. Yes, I think that is the central issue. I thought you were going to pick up another sentence from the section you read. I forgot about St. Louis. But I think there is a certain anomaly in

States welcoming foreign banks within their borders while prohibiting entry of U.S. banks from neighboring States.

I must say when I wrote that sentence I had in mind a newspaper story about a foreign bank entering into Chicago; a foreign bank that has already been operating in a number of other States was able to go into Chicago while other American banks, confined to a single State, are not able to do so. I'm not sure the logic behind that is immediately apparent.

To deal with your broad question, I would like to preserve a banking system that has a lot of diversity and room for small banks and not see downstate Illinois dominated by banks from St. Louis or upstate Illinois dominated by banks from Chicago. The legislative policy art would be to devise transitional and more permanent measures that would avoid some of the problems arising from the economic artificiality of State borders in this respect, but also preserve the kind of diversity in the banking system and lack of concentration that we want.

Senator DIXON. I would argue with you this bill doesn't do it.

Mr. VOLCKER. This bill doesn't touch the matter at all. You are starting, in a sense, with a clean sheet of paper on that issue.

Senator DIXON. Yes, but you see, while no one would argue with the soundness of your basic premise, when you say it doesn't make sense to have a Tokyo bank in the city of Chicago, if that's the one you have reference to, while you can't have a New York bank in the city of Chicago, no one would argue that.

Incidentally, no one would argue that there are legal methods of avoiding many of the branch banking restrictions in the State of Illinois, because you and I know, sitting here, that one bank, through a lot of careful manipulation, can acquire another one in my State and that it occurs from time to time.

Mr. VOLCKER. Or they can provide services electronically.

Senator DIXON. Sure, but I think one would have to recognize, Mr. Chairman, this is the fundamental thrust of my questioning; that there is a significant difference between what happens in the United States of America today, and there is a significant difference in what happens in my State of Illinois with all the multitude of banks there under existing laws, from what there would be with substantial relaxation and liberalization of those laws. Wouldn't you be willing to concede that without some kind of strict safeguards, the ambitious, aggressive, huge banks in the United States can ultimately dominate the financial structure in this country.

Mr. VOLCKER. I cannot conceive of doing this without safeguards of the type you are referring to, and maybe going rather slowly initially; there are a lot of different devices that can be used. Going back to the Tokyo bank in Chicago example, one possible approach—not exclusive, but in combination with other approaches—would be to permit some interstate banking within such large metropolitan areas as Chicago. The net result would be more banking outlets in the city of Chicago, or other large metropolitan areas, because there would be more direct participation by banks—or banking organizations— headquartered outside the State of Illinois; and similarly in other areas.

That is one possible approach, as I say, perhaps in combination with other approaches. Here in the District of Columbia, which I could also use as an example, there are three jurisdictions within a very limited geographic area, defining the scope of retail banking in this area.

Senator DIXON. I wouldn't quarrel with the logic of what you suggest, and no one here has a greater respect for your understanding of this question than this Senator, but I think all that we deal with here continues to be a series of responses to things that are happening in the country.

OPTIONS FOR PROTECTION OF THE PUBLIC INTEREST

You cite Sears—incidentally, that happens to be a fine Illinois institution—in connection with some of the things that they are undertaking. But what I concern myself with is the question of whether we are beginning to undertake a series of over-responses to some isolated problems in the country by virtue of which our adoption of liberalization of a variety of laws might significantly increase most of the things we are deploring in the course of some of your testimony. Does that make any sense to you?

Mr. VOLCKER. If I understand what you are saying, you are raising the basic question of how far you want to go.

Senator DIXON. Yes, I am.

Mr. VOLCKER. I would say two things. Left unattended, you are going to have a mess, because that's what——

Senator DIXON. But you might just have a little one.

Mr. VOLCKER. I think you can have a rather awkward one. If you think this kind of legislation goes too far, this is your opportunity to answer precisely the question of how far should we go. That's the basic point being raised and it should be debated and resolved. I think that is the issue being put to you, and it's not settled.

Senator DIXON. I wish the administration, and particularly people of your standing, with your independent reputation, would come up to us and suggest the places that we ought to put on the restrictions that would be protective of the public interest, the little businessman, the small farmer, and others who really have an important function to play in our society, as I see it.

Mr. VOLCKER. That's basically what we are trying to do. On the powers side we're saying, for instance, no corporate underwriting. We have expressed before, and we express again, considerable qualms about the area of real estate development. We have some problems with insurance. I have raised some questions in this testimony that seem to me to go precisely to those points. On interstate banking, I don't at all want to give the impression that I think this is a decision between nothing and everything. I do not see it as that kind of a decision at all. I think there are many devices which would have to be reviewed.

Senator Proxmire raised some questions with respect to the general competitive situation and the concentration of resources. You have raised some other questions. They are all perfectly valid questions. The issue seems to me to be how to make some progress in the direction of expansion, while taking full account of the kind of considerations you have in mind. Precisely what balance do you want to strike? I would certainly not propose that tomorrow you eliminate the Douglas amendment and the McFadden Act without some replacement to provide both transitional and more permanent limitations on concentration, avoidance of predatory practices, and the like.

Senator DIXON. My time has expired, Mr. Chairman, but I would welcome whatever you could give me in the form of a letter or other thoughts concerning the limitations that would be appropriate in your view.

Mr. VOLCKER. We would be glad to send you a letter outlining a range of options.

The CHAIRMAN. Mr. Trible.

Senator TRIBLE. Thank you, Mr. Chairman. Perhaps in light of having missed Mr. Volcker's testimony, and the questions, I would yield.

The CHAIRMAN. Senator Sasser.

CONCENTRATION OF FINANCIAL POWER AND BRAZIL'S FINANCES

Senator SASSER. Thank you. Mr. Chairman, the Wall Street Journal, in an article appearing a few weeks ago suggested that with the advent of full-scale banking deregulation, we would have only 50 major financial institutions in this country as opposed to the 5,000 to 9,000 that we have now. One vice president of a major accounting firm suggested that deregulation could bring about the creation of trillion-dollar banks. Frankly, I am troubled by the prospect of such concentrations of financial power in this country. My question to you is do you think the administration bill, which is currently before this committee, contains adequate safeguards to prevent undue concentration of financial power in our largest institutions?

Mr. VOLCKER. In general it contains safeguards, but we have proposed additional safeguards in that connection in our comments on the bill. Frankly, if we were to administer this statute, we would appreciate some further guidance from the Congress in some of these areas. I made a particular point of insurance and banking combinations. We have a position, but we also ask you the question: Would you want to see the largest banks combined with the largest insurance companies? I think that's an answer you have to give us.

Senator SASSER. Mr. Chairman, I for one would certainly like the assistance of the Federal Reserve Board and your experts there in supplying us with advice as to what we might expect and how we might expect our financial system to operate. If you get into a situation, with increased concentration——

Mr. VOLCKER. I do not see the concentration reaching anything like the proportions in the Wall Street Journal article you referred to. We would be glad to provide you with any further analysis we can, but I think this statement is replete with concerns along the lines that you have.

Senator SASSER. Yes.

Mr. VOLCKER. At some point you want to confine that.

Senator SASSER. Well, I appreciate your concerns, and I share them, and I will support you in your moratorium. I missed the earlier dialog here, but I think it would be helpful to have a cooling off period here, a period in which to sort of regroup and see where this thing is going.

I am troubled because many of our largest financial institutions are precisely the ones who are deeply enmeshed in the current international debt situation, which I think is a crisis situation. I was very troubled, yesterday morning, to see on one of the early morning television news programs a professor from some university, who had just returned from Brazil. He made the flat statement that the Brazilians aren't going to repay these debts. As a matter of fact, they are not even going to pay the interest. They are not going to tell us for a while; they are going to take this thing and shove it and push it around. But in the final analysis, politically, it's impossible for them to undertake the austerity measures that have been proposed for them to pay this indebtedness. What's your reaction to that, Mr. Chairman?

Mr. VOLCKER. Your question is whether they can service the loans in an orderly way. I think they are making every effort to do that after taking a long time and probably a number of, not quite false starts, but deviations. It appears we now have, or at least are on the verge of, an agreement between Brazil and the IMF on an economic adjustment program that has been carefully considered by both parties, and is deemed satisfactory.

That is a tough program, no doubt about it. It is going to require hard adjustments by Brazil, require a large effort on the part of Brazil, but I think it provides, at this point, the basis on which the continuity of Brazil's finances can be developed in cooperation with the IMF, and the commercial bank lenders and, to some extent, other governments.

I think we are making some progress there. I don't agree with the negative outlook, certainly not with the inevitability of the prognosis that you recite. Quite to the contrary, these debts can be manageable; they can be serviced over a period of time. It's going to take a lot of effort, but it's feasible.

I would point to the case of Mexico, where the same kind of comment was made a year ago. The problem isn't over, but there are signs of real progress and a restoration of more international liquidity within Mexico. They have the availability of more resources now than they had last summer. They have gone through a harsh adjustment process and are still going through a harsh adjustment process, but I think there are promising signs in that country. Brazil is at an earlier stage, but I don't share your pessimism.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Chairman Volcker, I am sorry I wasn't here to hear your statement, but we do welcome you to the committee. I might say, Mr. Chairman, by way of preamble, that once you pare away some of the politics of this issue—and these are not partisan politics, but are the kinds of politics of one set of institutions in the private sector and occasionally some in the public sector struggling for advantage one over another—but that's what the American enterprise system is all about, I suppose.

But, there is, beneath that level of struggle, a struggle that I think we are all engaged in, trying to come to grips with a meaningful public policy issue. The question of financial services industry integration really comes down to a tug of war between the increases in efficiency that could be obtained by deregulation of a variety of kinds, one of which is the Treasury proposal, and the extent to which that is offset by an increase in the vulnerability of that financial system—something that I note you, Chairman Volcker, have to be and are concerned about—and that, it seems to me, is the central substantive policy issue that we are all trying to get at in our various ways.

With that in mind, I understand in your remarks that you mentioned, conflicts of interest within fully integrated multifunctional financial companies and the problem of potential discrimination in the credit-granting process. Is my information correct?

Mr. VOLCKER. Yes.

BANKS AND SUBSIDIARIES NEED MORE REGULATION AND SUPERVISION

Senator HEINZ. Now, at the present time, because we have both sets of regulators that coincide with sets of institutions, the Fed and its member banks, the comptroller, the FDIC, the Home Loan Bank Board and so forth. At the State level we have insurance regulators, regulating the insurance industry. The real question, it would seem to me, once you integrate those institutions, but you keep all the regulators separate, how would the regulators ever detect conflicts of interest? How would the regulators be able to detect conflicts of interest? There would be no integrated regulator to police the integrated financial service company.

Mr. VOLCKER. In the Treasury bill, there would be an integrated regulator for a bank holding company. It would be the Federal Reserve. Then there would be another regulator for the savings and loan holding companies, the Federal Home Loan Bank Board. There would not be a lot of banking agencies involved in the holding company. I think the present system has operated tolerably well. I don't see that as an impossible problem at all.

There is a problem area, which I touched upon at some length in my statement, that as savings and loans become more and more like banks, you will, I think, get forced into the logical position that the regulatory authorities—and the rules and regulations governing that activity—become more congruent with banking.

The Treasury bill says that a savings and loan holding company will have to follow the same rules on nonbanking or nonthrift powers that a bank does. I think that is the logic of the situation, as those institutions become more alike.

If individual thrift institutions are conceived of as specialized mortgage lenders—and that is true with a great bulk of them today—and if they remain basically as specialized mortgage lenders, then I think the logic is that they can be regulated somewhat differently. My testimony specifically says they might retain many of the present arrangements of the unitary savings and loan holding company, with some exceptions. You could take a different kind of regulatory approach toward those institutions if they are, in fact, specialized. If not, there's no logic to that.

Senator **Heinz**. Under the Treasury proposal, a bank holding company may have a variety of separate subsidiaries.

Mr. **Volcker**. Right.

Senator **Heinz**. I believe your testimony and position is that that does not really constitute full insulation of the bank.

Mr. **Volcker**. Not by itself, no.

Senator **Heinz**. From problems, whether they be problems with the financial risk and failure problems, and we have had other testimony for the subcommittee supporting that—your position on that. Hence the question, if you have regulators such as the Fed, in the case of the bank holding company activities, who does not necessarily proclaim itself an expert in the areas of these separate cells, insurance, real estate investment trusts, what have you?

Mr. **Volcker**. Right.

Senator **Heinz**. What guarantee do we have that the regulator in charge is going to be able to have sufficiently early warning to take the necessary steps to head off problems with at least the same rapidity as we do now?

Mr. **Volcker**. We are not living in a world of perfection; we don't always get those early warnings now, within the bank itself and its alleged subsidiaries, but we are satisfied that the general approach taken in the administration bill is satisfactory. In some of these areas, of course, you will have another regulator exercising primary supervision and regulation over that institution. Our role would be very secondary, but we would have access to the regulator's reports. If we had reason to believe that something was going wrong, that threatened the holding company as a whole—particularly the bank component of it—we could then demand additional data for ourselves and use our examining resources to look into the matter.

But I would hope and expect in many of these areas that this need would be extremely limited. You basically rely upon the primary supervisory authority. In other areas, like real estate development, there is no primary supervisory authority. I explore that issue very directly, in my testimony, and raise the question and express, I think, an intention—but it's an intention that you might want to amplify in legislation or reinforce or tell us it's not a good idea—that for some transitional period leveraging restrictions might be a part of our supervisory approach.

Real estate development is a vague term. We would expect to provide a little closer definition of what real estate development is and what kinds of development would and would not be permitted as part of the bank holding company—precisely the kind of concerns that you raised.

Senator **Heinz**. Should banks be allowed through a bank holding company to own, unsupervised by the Fed, totally outright, exporting companies?

Mr. **Volcker**. You say "totally unregulated." There should be some way, as provided in this bill, of appraising what's going on and seeing whether there are any risks; there should be some ability to put some limitations on the activities.

Senator **Heinz**. I used the term "unregulated." I didn't use the term "unsupervised."

Mr. **Volcker**. All right

Senator **Heinz**. You are both a supervisor and a regulator.

Mr. **Volcker**. Right. We do have some regulations which follow the law that you passed, and I think that's rather——

Senator **Heinz**. That's why I asked the question. As you know, I am curious as to whether your view, or the view of the Fed—whether it would not be a good idea for banks to have anything more than minority interests.

Mr. **Volcker**. As you recall, the bill went further, than we really recommended. The banker relationship was the major difference, as I recall it.

Senator **Heinz**. Well, the reason I asked that is, partly, just to find out how far your thinking has come, but also to learn and to wrap up the last question.

I would like—since my time is over, I would like to come back, if possible, and explore why the supervisory agency, when it deals with a bank holding company that has a large variety of interests, very different from what they have now, will not be in the position of a proverbial blind man trying to assess the elephant. But my time has expired. But I think we need to get into that.

Mr. **Volcker**. I would respond very briefly by saying a judgment on that matter is one of the questions we would have to consider in deciding upon the full scope of these activities.

The **Chairman**. Senator Heinz, let me just say, if you want to finish up on that one question because Senator Proxmire and I have a large number of additional questions that we want to submit for the record.

Senator **Heinz**. I think it's going to take more than one or two quick questions, Mr. Chairman. I thank you for the opportunity but I will submit my questions as well.

The **Chairman**. Mr. Chairman, there are a lot of technical subjects that we need your advice and comment on. Besides Senator Proxmire and I, having many additional questions, we would like you to answer for the record in detail, other members of the committee do as well. There is a complete briefing going on in the Capitol for all Members of the Senate and those that had to leave and could not be here wished me to express in their behalf that it was an important briefing and why they could not be here. But this is a very complex, difficult and controversial subject. Certainly your testimony verbally today, or even your responses in writing to our question, are not the end of the subject. We will undoubtedly, before we resolve these, have you back many times again. We thank you very much for your testimony today.

Mr. **Volcker**. Thank you, Mr. Chairman, I appreciate being here.

[Response to committee written questions follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

October 24, 1983

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Garn:

Your letter of September 19 requests my responses to certain questions concerning S.1532, S.1609 and S.1682, which deal with moratoriums on acquisitions and financial institution deregulation. My responses to your questions are provided below.

1. Some have argued that our major structural banking laws -- Glass-Steagall and the Bank Holding Company Act -- no longer make any sense in today's marketplace. There has been too much erosion because of loop-holes and that we have reached the point where it will be impossible to resurrect these laws. The conclusion is that we either ought to repeal these laws or let the forces of the marketplace develop unchecked for another year or two and then ratify what has occurred. What do you think of this scenario?

As I advised your committee during my testimony on September 13, there can be no doubt that a reexamination of the existing legislative framework has become urgent. However, I believe that the underlying premises of the Bank Holding Company Act and the Glass-Steagall Act continue to make sense. These statutes embody the strong tradition in the United States of a separation between banking and commerce. In my view such separation is necessary to maintain the safety and soundness of the banking system as well as to avoid potential harmful conflicts of interest, excessive concentration of resources, and undue risk. At the same time, the line separating banking from commerce needs to be reexamined in view of the changes in the financial industry that have resulted from market incentives, customer needs, and new technology.

The legislation that the Administration has proposed, and that the Federal Reserve supports, would accomplish this objective by simplifying the supervisory procedures applicable to bank holding companies and allowing them to engage in an expanded range of financial activities while also maintaining the broad distinctions between banking and commerce. In my view, a carefully developed legislative package such as that which the Administration has proposed is far preferable to allowing the forces of the marketplace to continue to alter our financial system in a manner which I believe is both haphazard and potentially dangerous. We have already seen that when left unchecked, market forces acting alone result in competitive inequalities because some institutions are able to take advantage of loopholes or ambiguities in the existing legal fabric and others are not. In addition, the present situation is inconsistent with the goals of soundness, public confidence, and continuity in the provision of money and payment services that are essential for a stable banking system. In my view, the Administration Bill represents a reasonable compromise between market forces and these public policy objectives.

2. On pages 12 and 13 of your testimony, you suggest that present law should be changed so that the Federal Reserve is not required to review competitive factors when approving new activities for bank holding companies. You suggest that this activity can be handled by the Justice Department. Do you believe that the Antitrust Division at Justice should review new activities for bank holding companies before they are approved -- or be limited to bringing a subsequent antitrust suit after competitive problems arise?

One of the principal objectives of the Administration Bill is to streamline the process by which bank holding companies may commence new nonbanking activities. I would be hesitant, therefore, to create any additional requirement for prior notice to the Department of Justice before bank holding companies could engage in such activities. The Hart-Scott-Rodino Act presently requires prior notice to the Department of Justice and the Federal Trade Commission at least 30 days before consummation of any major nonbanking acquisition by a bank holding company, and I do not believe that any additional procedures are necessary to ensure the adequate enforcement of our antitrust laws.

3. You have stated that you think the moratorium should be temporary, to allow Congress to make "permanent", well-considered changes. If, at the end of the moratorium period, Congress had not acted, would you refuse to support an extension of the moratorium?

The Federal Reserve proposed moratorium was originally for a six month period ending at the conclusion of this year. A six month moratorium from now would still appear reasonable in light of the present situation. If at the end of that time, a great deal of progress had been made, and the Congress was on the verge of passing a bill, I might favor a very short extension of the moratorium to allow Congress to complete its work. Alternatively, and perhaps more likely in such circumstances, the provisions of the substantive bill itself, with the effective date and any grandfather dates set in the proposal, would avoid any clear need to maintain a moratorium in place. I do not foresee a blanket extension of the moratorium. I fully recognize that the moratorium legislation alone is not a remedy to the current disarray in the financial industry since it does not address the need to expand the nonbanking powers of bank holding companies and to streamline the procedures for commencing new activities. If general legislation is not possible, we might eventually be led into the de facto evolution you describe, but it is difficult for me to see that that approach would better advance the public interest.

4. Why does the moratorium bill propose to block future acquisitions of banks and thrifts by nonbanking companies? Do you feel that these developments have been, are, or will be dangerous to the banking system? Would you recommend that these acquisitions continue to be blocked beyond the moratorium, as a matter of public policy?

The ownership of banks and thrifts by nonbanking companies is inconsistent with the principle that banking and commerce should be separated. As indicated above, application of this principle is necessary to maintain a sound banking system and to avoid conflicts of interest and other adverse effects that may result from the combination of banking and commerce. In my view, permitting affiliations between banks and companies engaged in general commercial activities presents a significant potential for adverse effects on the banking system, particularly when the nonbanking company is engaged in lines of business which involve substantial risk or may be closely integrated with "banking" functions. Consequently, I believe that the acquisition of banks and thrifts by nonbanking companies should in general be prohibited after the conclusion of any moratorium period, and for this reason I favor the provisions of the Administration Bill that would generally prevent such acquisitions except where bank holding companies were permitted to engage in the same line of activity.

5. The moratorium prohibits acquisitions of "insured banks" by certain nonbanking firms and also expands the definition of insured bank and "banks". Insured banks are those which are FDIC insured and those eligible for insurance. Also, the bill says that a bank is one which makes commercial loans and accepts deposits that may be transferred by check. As a result of these definitions, how many more institutions may not be acquired? What kinds of institutions? Do you intend that these provisions should continue as permanent law?

The bank definition that we have proposed in our moratorium bill has gained wide support. It is also contained in the Administration Bill and the moratorium bills suggested by Chairman St Germain and the FDIC. The applicability of this definition to FDIC insured institutions would cover all of the 14,500 commercial banks and 315 savings banks presently insured by the FDIC. With the exception of the 50 or so "nonbank banks" created in the last few years, all of the commercial banks mentioned above are already covered under the current bank definition.

Although a broadening of the scope of the bank definition beyond institutions that are federally insured should be carefully examined to assure that we are not covering more than necessary, it is our initial judgement that the broader definition is necessary to prevent the development of further loopholes of the kind that this legislation is intended to close. Adding the standard of eligibility for FDIC insurance to the bank definition would primarily encompass industrial banks, savings banks, and some industrial loan companies that are now eligible for FDIC insurance but have not secured such insurance. The functional test based on commercial lending and the acceptance of transaction accounts would encompass the remaining industrial loan companies, as well as savings and loan associations not insured by the FSLIC, but only if these institutions performed both of the listed functions. Since the institutions in question are exclusively state chartered, exact figures are difficult to obtain, but it appears that there are approximately 1,000 industrial banks and industrial loan companies, 160 savings banks, and 450 S&Ls that could be covered by the "eligibility" and "functional" portions of the proposed definition. We understand, however, that many of the industrial loan companies are very small institutions that do not offer transaction accounts and therefore would not be covered. Moreover, many savings banks and S&Ls are mutual in form and thus would be unaffected by the definitional change. With regard to the desirability of continuing this definition permanently, the bank definition that is contained in our moratorium bill is also contained in the Administration Bill which we support, and we would therefore intend that these or similar provisions continue as permanent law.

6. The Fed recently proposed a revised Regulation Y. That proposal would greatly expand the definition of "commercial loan", and thus, the definition of "bank", under the Bank Holding Company Act. As a result, more institutions would come under Fed jurisdiction and be blocked from combining with nonbanking firms. Since Congress is now considering the "definition of bank" issue, do you intend to drop that part of the Reg. Y revision? If not, why not?

The expanded "commercial loan" definition is part of a major revision of Regulation Y to clarify its terms, to speed and simplify the applications process, and to incorporate outstanding Board rulings applying the Bank Holding Company Act's provisions. Some time before the Regulation Y revision was announced, the Board had defined the term "commercial loan" to include any transaction representing a credit extension to a commercial organization. This definition was adopted in order to halt the pronounced and accelerated trend by nonbanking organizations to acquire banks. In proposing its revision of Regulation Y the Board believed it appropriate to incorporate all important interpretations of the Act's provisions, including the Board's definition of commercial loan, and to ask for public comment on these positions.

As we see it, the inclusion of the commercial loan definition in the Regulation Y revision would preserve the options of Congress in dealing with this issue since it is designed to maintain the status-quo, and prevent continuation of the disorderly process by which nonbanking organizations are breaching the barrier between banking and commerce. However, the Board has not yet reviewed the public comments submitted on the Regulation Y proposal and has not made any decision on whether to include the definition of bank in the final regulation.

7. Section 2 of the Moratorium Bill states "no company shall acquire control of insured banks in more than one state" without prior approval under the Bank Holding Company Act. If this provision were enacted, under what circumstances would the Fed allow acquisitions, and when would it deny acquisitions? Would you want this recommendation to be a permanent change beyond the moratorium period?

Under this provision of the Moratorium Bill acquisitions that are consistent with the interstate banking prohibitions contained in the Bank Holding Company Act would continue to be permitted. Thus, for example, the Board would continue to approve applications where a given state invites entry by out-of-state organizations or where the acquisition involves a trust company that does not generally accept deposits other than in a fiduciary capacity. Other proposals that are inconsistent with the interstate banking prohibitions would be rejected. This provision of the Moratorium Bill is intended to insure that the Board has the ability to prevent the formation of multi-state banking organizations that would violate the interstate banking prohibition contained in the Act. For this reason, it seems desirable to have such a clarification of the Board's authority so long as the basic prohibitions of the Act are maintained. We would, however, urge the Congress to reconsider the nature of the present prohibitions on inter-state banking as part of its legislative review, and any authority provided the Board should be reviewed in that light.

I hope this information is useful to your Committee. Please let me know if I can be of further assistance.

Sincerely,

Paul

The **Chairman.** Next I would like to call to the witness table Hon. Edwin J. Gray, Chairman, Federal Home Loan Bank Board.

[Discussion off the record.]

The **Chairman.** The committee will come to order. Those of you who are leaving, please leave quietly. There is plenty of space in the hall for conversation, so we can continue with the testimony.

Mr. Chairman, we are happy to have you before the committee today. If you would like to proceed.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD

Mr. **Gray.** Mr. Chairman and distinguished members of the committee: I appreciate the opportunity to appear before you today, and to accept your invitation, Mr. Chairman, because it was this distinguished committee which, under your leadership, took the initiative to forge the most monumental legislation to affect the thrift industry in more than half a century.

What emerged from the Congress just 12 months ago, in what is now familiarly known as the Garn-St Germain Act, was a reaffirmation of the fundamental mission of the Nation's thrift institutions: to promote home ownership as a key objective of public policy and to serve as the primary conduit of mortgage credit to American families.

The preamble to that act provided the clearest possible statement of the intent of Congress. It reads: "An Act to revitalize the housing industry, by strengthening the financial stability of home mortgage lending institutions and insuring the availability of home mortgage loans."

That legislation was not intended, as some claim, to transform thrifts into commercial banks—despite the comparatively very limited new asset authorities it granted. Rather, the act expressly stated that the limited new powers conferred upon federally chartered thrift institutions were intended "to provide such institutions the flexibility necessary to maintain their role of providing credit to housing."

I strongly disagree with those who conclude that Garn-St Germain somehow made thrifts essentially commercial banks. Any objective examination will demonstrate that Federal thrifts are severely limited by asset basket restrictions—compared to the wide open, unrestricted asset powers available to commercial banks. To claim some sort of parity of powers is to simply ignore the wide gulf which differentiates the purpose and practices of these two distinct forms of depository institutions and the separate and distinct regulatory systems which govern their operations.

These are important points because if one concludes that as a result of the Garn-St Germain Act thrifts and banks are alike, then it can be argued much more easily that the holding company treatment for banks and savings and loans should be alike. Indeed, the contention that there is no real difference between these types of depository institutions would establish the basis for insisting they ought to be regulated in the same manner, and perhaps even by the same regulator. The Federal Home Loan Bank Board emphatically rejects such arguments as having no basis in fact, in law or in actual practice.

More than a decade ago, the Congress established a separate holding company structure for thrifts. Now this has become the focus of legislation you are considering. Before enacting the Garn-St Germain Act, Congress completed a review of the entire savings and loan holding company structure. By deciding to retain the structure in its present form, Congress reaffirmed its belief that the added flexibility provided by this format was, indeed, an appropriate supplement to the limited asset powers of thrifts. The only restrictions imposed by Congress on unitary savings and loan holding companies were aimed at insuring the continued focus by the thrift subsidiary on the traditional home financing function.

In my opinion, the underlying justification for scaling back the thrifts' unitary holding company structure to the equivalent of commercial banks is founded on the faulty premise that thrifts and commercial banks are now essentially the same.

Any legislative change which would diminish the perceived value of the thrift charter among investors wishing to infuse badly needed equity capital into thrifts wishing to convert from mutual to stock form would represent a setback to the industry's efforts to rebuild its capital base. Thus far in 1983, more than 40 thrifts have converted to stock resulting in an infusion of $2 billion in new capital—more than three times the capital raised through conversions during the entire previous history of the thrift industry.

More than three out of every four thrift institutions are depositor-owned mutuals which depend primarily on retained earnings for capital. I am deeply concerned that any move by the Congress at this time to substantially alter the holding company structure of thrifts—or service corporation authorities which serve as profit centers for S&L's—would have a pronounced negative effect on the healthy trend we have been seeing in conversions from mutual to equity ownership of these institutions.

FEDERAL RESERVE INTRUSION INTO THRIFTS DANGEROUS AND NOT NEEDED

Despite our opposition to proposals that reject the positive approach to unitary savings and loan holding companies taken by the Garn-St Gemain Act, there is one type of affiliation which raises significant concerns in our minds. The combination of investment and depository banking under one corporate roof has been recognized through the years as presenting a unique potential for conflict of interest and risk. Further, we question philosophically to what extent the limited resources of Federal Deposit Insurance should serve as a guarantee for finanical instruments developed and marketed by securities firms. The magnitude of such transactions, and the risks and policy questions they raise, would likely be exacerbated were an investment banking firm to own its own thrift. Given the present fragile condition of the thrift industry and the concerns we have raised in our written testimony, we believe the committee should carefully consider the serious implications of acquisitions of depository institutions—including thrifts—by securities underwriting firms.

The legislation now before you would, for the first time in a half century, inject into the mainstream thrift regulatory process the prerogatives of a regulator of commercial banks—namely the Federal Reserve Board.

Such an intrusion into the thrift regulatory arena would only serve to add substantial credibility to the notion that the public policy purposes of thrifts are no longer truly distinct from those of commercial banks. This is not a turf issue. However, after all those years, for a commercial banking regulator to either seek or find novel regulatory authority over institutions whose mission is clearly very different—institutions which I believe have been effectively governed for regulatory purposes by the Federal Home Loan Bank Board for many years—would surely send a confusing signal to the entire housing industry. I believe it is in the public interest to maintain an entirely separate regulatory structure for thrifts so long as the Congress determines that the fundamental role of these mortgage lending institutions should remain distinct from commercial banks. I therefore reject the case for authorizing the Federal Reserve Board to determine permissible activities for thrift holding company affiliates.

It is my earnest hope that this committee will examine the legislative initiatives pending before you with extraordinary care. In particular, I would ask that you look very carefully at the whole notion that our financial system is in a chaotic state demanding instant and drastic congressional action.

I would suggest that you be very skeptical of the whole concept of dealing with what may be, in some cases, perceived problems in the financial system—especially by way of the moratorium device.

As thrift institutions themselves demonstrated over a long period with regard to rate control on deposits, a determined industry can be very successful at securing renewal of moratorium legislation on a fairly routine basis. Given the various influential interest groups that would be affected, groups which would be highly motivated to seek perpetual renewal of a moratorium in this area, I believe that any initiatives under consideration should be analyzed solely in terms of their desirability as permanent legislation.

Finally, let me say that the thrift industry continues to be in the most fragile stage of recovery. Even the recent upturn in money market rates—which was moderate compared to the run-up in rates in the 1980–82 period—is having a negative effect on thrift earnings. While spreads on earning assets had begun to move back into the black during the first part of 1983, today's interest rate environment is causing many institutions to slip back into the red. The industry remains gravely vulnerable to upward interest rate fluctuations.

It is important for all of us to be reminded that during 1981 and 1982 alone, nearly one-quarter of the industry's net worth was lost and more than 700 institutions disappeared.

Common misperceptions continue to exist regarding the financial progress of the industry, and they need to be corrected. The business has a long, long way to go to regain its health. Fragile as the industry is, any legislative change which would have even the unintended effect of harming the chances of the business to recover its strength would serve no constructive purpose. Mr. Chairman, I believe this committee, in particular, will be especially cognizant of the concerns I have raised because just a year ago the basis for survival of the industry was fashioned so well in the legislation which now bears your name.

I would be pleased to answer any questions the Committee may have.

[The complete statement follows:]

STATEMENT OF EDWIN J. GRAY, CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and distinguished Members of this Committee:

I appreciate the opportunity to appear before you today to discuss the distinctive roles played by, and the relationships between, commercial banks and thrift institutions and, as part of that consideration, their relationship as depository institutions to non-depository organizations.

I am particularly pleased, Mr. Chairman, to accept your invitation because it was this distinguished Committee which, under your leadership, took the initiative to forge the most monumental piece of legislation to affect the thrift industry in more than half a century.

During the 18 months this Committee and other Members of the House and Senate deliberated on the range of options which ultimately led to passage of what is now familiarly known as the Garn-St Germain Act, the Congress fashioned the most comprehensive reform of its type since the early 1930's.

The parties which were to be affected by the Garn-St Germain Act had extensive opportunity to make their views known through the legislative process. That long and deliberative process produced a legislative package of truly historic dimensions. To suggest, as some have, that the Congress did not really understand either the detailed provisions of the legislation or the ramifications it would have, or that the Act was only meant to be a temporary phenomenon, is, I believe, just plain wrong.

Now, scarcely a year after the passage of the Garn-St Germain Act, the Committee is taking up yet another set of legislative proposals which, were they to be adopted as introduced, would seriously alter the legislative character of the 1982 Act and effectively rescind certain legislative reaffirmations of the appropriateness of longstanding savings and loan holding company law.

While I recognize that the legislative process is an ongoing one, I believe, in my role as the chief regulator of the thrift industry, that the wisdom which ultimately fashioned the Garn-St Germain Act provided a definite basis for the survival of the industry in the long term.

Having played a minor role in what I would describe as the "Garn-St Germain process" as a member of the Administration, I must say that, in my opinion, any significant revision of either the key provisions or legislative reaffirmations made by that Act could undercut its therapeutic value to a very hard-pressed, currently very fragile, thrift industry.

Concerned as I am about the importance of the survival of this industry -- especially at this time of unprecedented challenge and required adaptation to an unfamiliar, deregulated environment for the thrifts -- I feel it necessary to urge great caution by Members of the Committee regarding any proposals before you which could impact unfavorably on thrift institutions across the nation.

It is my intention to offer the Committee the perspectives of the Federal Home Loan Bank Board on the unique mandate assigned to institutions to act as the primary providers of mortgage credit to American families in the nation's financial system.

I will, in the course of this testimony, urge the Committee to reaffirm, as successive Congresses have effectively done for the past 50 years, the principal housing finance role of the thrifts and the separate regulatory apparatus which governs their operations.

As I have already said, I will urge the Committee today to proceed with extreme caution with respect to any proposals which would deprive thrifts of critical sources of capital and income. In this connection, the Bank Board believes that any legislative proposals that ignore the troubling consequences which could ensue for the thrift industry, now and in the future, could undermine both the health of the nation's housing sector and the general stability of our overall financial system.

Thrifts and banks are vital components of our economy. Their apparent similarity belies their very different functions. While banks have served as sources of credit primarily for commercial purposes, the historic role of thrifts -- fashioned and encouraged by the Congress for many, many years -- has been to provide home financing for the nation.

Since the first thrift was established 152 years ago, such institutions have grown into the largest single source of home financing in America.

When the Great Depression of the 1930s threatened the survival of the thrift industry, Congress took a series of steps to ensure that the thrifts would continue to meet the mortgage credit needs of the country.

In 1932, Congress enacted the Federal Home Loan Bank Act to provide thrifts access to liquidity, enabling them to continue to make mortgages. A year later, as a means of extending housing credit to areas of the country which were inadequately served, the Congress created the federal savings and loan association as an institution under the Home Owners' Loan Act. In 1934, the Federal Savings and Loan Insurance Corporation was established to insure deposits and thereby to help thrifts attract funds to finance mortgages.

In sum, these actions created a separate and distinct framework for regulating, insuring and extending credit to private sector housing finance institutions. The basic apparatus became known as the Federal Home Loan Bank System whose public purpose was to encourage private sector financial institutions -- not the government -- to assume the principal responsibility for home finance in their communities.

I believe the wisdom of that arrangement has contributed more to making us a nation of homeowners through the years than any other factor.

I need not remind this Committee about the deteriorating financial conditions the thrifts began to experience as they entered the 1980's except to highlight how serious the situation became in 1981 and 1982. During those two years, the thrift industry suffered staggering losses in net worth which approached one quarter of its capital. More than 700 institutions disappeared.

As the health of the industry declined and concerns about the strength of the FSLIC grew, this Committee confronted the problems directly.

In fashioning and then passing the Garn-St Germain Act, the Congress made clear its intent. The Preamble to the statute states: "An Act to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans."

While the legislation did expand in a very limited way new asset authorities for thrift institutions, these new powers fell far short of the longstanding, wide open and virtually unrestricted asset powers of commercial banks themselves. Indeed, the new thrift powers were intended simply to provide the kind of flexibility necessary for thrifts to be able to achieve some measure of portfolio diversification in order to better compete in a changing financial environment and to more effectively cope with interest rate volatility and cycles of economic instability.

In this most important regard, the new authorities were granted to thrifts by the Garn-St Germain Act to strengthen their ability to continue to play their primary role: to serve the mortgage needs of the American family.

The new thrift powers were not intended by Garn-St Germain to transform thrifts into commercial banks. On the contrary, the Act declares forthrightly that the new asset authorities were intended "to provide such institutions the flexibility necessary to maintain their role of providing credit to housing."

Any objective examination will demonstrate that federal savings and loan institutions are severely limited in the asset authorities granted to them under the law by very substantial asset basket restrictions, compared with unrestricted powers long enjoyed by commercial banks.

This is a very important point because if one mistakenly concludes that as a result of the Garn-St Germain Act, thrifts and banks are alike, or are essentially the same, it can be argued much more easily that the holding company treatment for banks and savings and loans should be alike, or essentially the same.

Indeed, the contention that there is no real difference between these types of depository institutions would establish the basis for insisting that they ought to be regulated in the same manner, and perhaps even by the same regulator.

The Federal Home Loan Bank Board emphatically rejects such arguments as having no basis in fact, in law or in practice.

The fundamental missions of banks and thrifts remain as distinct as ever. While some federal thrifts are now beginning actively to explore the comparatively very limited new asset authorities granted to them last year, the fact that in the month of June alone thrift institutions made $13.4 billion in mortgage loans -- the largest monthly amount in history -- confirms that the overwhelming emphasis of thrifts continues to be mortgage lending.

This commitment to mortgage lending arises because, unlike commercial banks, federal thrifts have a unique statutory mandate to provide funds for housing credit. The specific investment authority of federal thrifts today, as it always has been, is targeted to their main mission -- the provision of real estate finance to housing consumers -- a function separate and distinct from that of commercial banks. Moreover under the Federal Home Loan Bank Act, their membership in the Federal Home Loan Bank system hinges upon their acting in a manner consistent with the provision of home finance.

Congress' intent to preserve the long-standing, unique function of thrifts is apparent from provisions in the Garn-St Germain Act which sharply penalize commercial lending activities. For example, a unitary savings and loan holding company whose insured institution fails to maintain a specified percentage of assets in housing-related loans is limited to the more restricted powers available to multiple holding companies. In addition, with certain exceptions, a federal thrift that fails to maintain its housing orientation may not branch interstate. By creating these limits, Congress obviously specifically intended, and in its wisdom has provided, the necessary incentives to insure that thrifts continue to function in their historic role as providers of credit for the nation's homebuyers.

The powers conferred by the Garn-St Germain Act are so very important because they provide thrifts with the tools to survive in the long run, despite the vagaries of future business cycles. However, the process of recovery for the thrift industry will be a long and arduous one. It will take time and the commitment of institutions to restructure their asset and liability portfolios as they learn how to make more effective use of their new powers.

Today, the thrift industry continues to be in the most fragile possible stage of recovery. Rate-sensitive as the industry is, the recent upturn in interest rates -- although moderate compared to the run-up rates in the 1980-through-1982 period -- is having a marked effect on thrift earnings and underscores the continued frail condition of the thrift business generally. While spreads on earning assets had begun to move back into the black during the first part of 1983, today's interest rate environment is causing many institutions to slip back into the red. The industry remains gravely vulnerable to upward interest rate fluctuations.

The Board believes that several factors, which I will touch upon briefly at the outset, are vital to the continued recovery of the thrift industry. First, the attractiveness of a thrift charter must be maintained and enhanced, not reduced or diminished, so that the flow of new capital into the industry will be encouraged. The present trend of conversions to stock form provides an important source of new capital and offers added flexibility to the resulting institution. Thus far in 1983, more than 40 thrifts have converted to stock -- well above the 33 institutions which did so in all of 1982. Thus far this year, conversions have infused $2 billion in new capital to the thrift industry. The significance of this is that throughout the entire history of the thrift industry, until the end of last year, such conversions had produced a total of $600 million. Acquisitions of institutions also can provide beneficial infusions of capital in certain circumstances.

The Board also strongly supports an expansion of the secondary mortgage market and the integration of variable rate instruments into that market. This secondary market will play a critical role in ensuring thrifts' ability to continue to originate mortgages in the coming decades, under a variety of economic scenarios.

The Board also believes that federal thrifts' ability to remain consistently active in the housing credit market is dependent upon their ability to conduct a meaningful amount of activities that produce an income stream to offset variations in the value of their mortgage portfolios caused by interest rate fluctuations. It is essential that thrifts retain their present authority to offset such fluctuations. The Board believes that the current service corporation investment authority is one of the most important means to provide this necessary flexibility and therefore must not be undermined.

Congress has clearly recognized the need to maintain a separate and distinct thrift industry as a primary source of funds for housing finance. In light of this, and of the Board's unique structural ability to respond to the needs and problems of this vital industry, we believe the present successful regulatory structure of the Board serves as a model for regulation of distinct types of financial institutions. Moreover, preserving a regulatory entity strongly committed to the goal of housing finance is crucial to the continued commitment of the nation's thrift institutions to mortgage lending.

CURRENT LEGISLATIVE PROPOSALS

Mr. Chairman, Congress currently has before it a number of proposals, some of which are the specific focus of these hearings, that would effect various changes in our financial system. The proposals generally have the announced goals of enhancing competition, promoting deregulation and staving off financial chaos.

It is my earnest hope that this Committee will examine these initiatives with extraordinary care regarding their actual -- as opposed to rhetorical -- relationship to these objectives and to the current economic context. In particular, I urge you, as a threshold matter, to look very carefully at the whole notion that our financial system is in a chaotic state demanding instant and drastic Congressional action.

I would also suggest that you be very skeptical of the whole concept of dealing with perceived problems in the financial system, and especially by way of the moratorium device. As thrift institutions demonstrated over a long period, with regard to rate control on deposits, a determined industry can be very successful at securing renewal of moratorium legislation on a fairly routine basis. Given the various influential interest groups that would be highly motivated to seek perpetual renewal of a moratorium in this area, I am totally convinced that any initiatives under consideration should be analyzed solely in terms of their desirability as permanent legislation.

Looking at the bills before you, from my standpoint as a thrift regulator, my dominant concern is that certain features of the proposals would impair the ability of federal thrifts to perform their unique housing mission. As I suggested earlier, in a very real sense, these initiatives represent an attempt at a counter-revolution against the Garn-St Germain Act, the fundamental thrust of which, to reiterate, was to reduce somewhat the competitive advantages favoring commercial banks over savings institutions, in order to provide the basis for thrift survival so as to maintain their role of providing credit for housing.

They would bring about this retrograde movement in a number of ways, including sharply curtailing thrift service corporation authority, and drastically diminishing savings and loan holding company authority. In at least one instance, this would be accompanied by displacement of key regulatory authority over thrifts from the Federal Home Loan Bank Board to the Federal Reserve Board.

A successful guerilla-like assault on the Garn-St Germain Act would have a very important negative effect on thrift earnings, competitiveness and capital-raising ability, and damage the Bank Board's regulatory effectiveness by diluting its authority.

REDUCTION OF SERVICE CORPORATION AUTHORITY

To articulate my concerns more specifically, I believe it would be extremely damaging for Congress to embrace any legislative proposal that would undermine the current vital contribution of service corporation diversification at the expense of the overall financial health of federal thrifts.

Historically, federal thrift service corporations have served as valuable profit centers contributing high earnings and increasing the net worth of the industry. For example, in 1981, when federally-chartered thrifts had losses amounting to $1.9 billion, service corporations were contributing a positive $211 million in profits to the nation's thrifts. In 1982, when federally-chartered thrift net losses nationally increased even more, to $3.2 billion, service corporations were contributing a positive $157 million to thrift income. Indeed, the Board's records dating back to 1975 indicate that service corporations have always added to the overall net worth of the industry.

In the process of enacting the Garn-St Germain Act, Congress very carefully examined activities available to service corporations. While the drafters of the Conference Report on the Act indicated an intent temporarily to limit further regulatory expansion of permissible service corporation activities, Congress took no action to cut back existing activity or authority in this area. That decision reaffirmed Congress' belief that current service corporation powers of federal thrifts are not only appropriate, but necessary to the health of the industry and its primary housing mission.

The Board strongly opposes any legislation that would result in further restrictions, limitations or "freezes" on service corporation activities and the Board's ability to regulate service corporation activities.

One proposal before this Committee, for example, would limit service corporations of federal associations to performing essentially clerical-type activities for other depository institutions -- except for service corporations which would be provided with limited "grandfather" rights. For stock associations, this grandfathering would extend only to activities actually performed on a specified grandfathered date, and conducted continuously thereafter. For mutuals, their service corporation authority -- rather than actual activities -- would be frozen as of that date. Apparently this approach is intended to compel activities now conducted by service corporations to be relocated in holding company affiliates, on the grounds that this structure would eliminate an alleged competitive advantage that thrifts enjoy over commercial banks. The Bank Board disagrees with these assumptions and is deeply troubled by the implications of such a reduction in service corporation authority for federal thrifts.

First, there is no indication that service corporations have adversely affected their thrift parents. To the contrary, as discussed above, service corporation profits have consistently made a positive contribution to industry soundness.

Second, any reduction in current authority would deprive federal thrifts of important profit-generating activities, especially real estate ventures for which these institutions have great expertise and in which they have had much success. This change would bar existing and new stock S&L's from conducting new activities already determined by the Board to be reasonably related to thrift activities.

Even worse, an existing stock association service corporation would lose all its grandfathered rights to conduct activities engaged in on July 1, 1983, if it commenced any new activities which would have been legal on that date. In effect, these associations would be totally deprived of management discretion to start up complementary activities which would be the most efficient and profitable route to meet competition and enhance the health of both the parent and the service corporation. For example, a stock S&L service corporation actually engaged in mortgage banking on July 1, 1983, could not in the future offer home ownership and financial counselling services.

Third, this proposal would place such a heavy penalty on using the stock form, that mutuals might simply elect not to convert -- depriving the industry of a much needed source of capital. As I have already mentioned, thus far in 1983, $2 billion in new capital has been infused into the thrift industry. Proposals which place greater restrictions on stock institutions than on mutual associations also would tend to diminish the perceived market value of the thrift charter among those investors considering investing in thrifts converting from mutual to stock form, and could therefore represent a setback to the industry's efforts to rebuild its capital base.

Fourth, proposals which would arbitrarily require thrift management to restructure service corporation activities into a holding company format would force an unnecessary expenditure of time, effort and money. Absent compelling factors of safety and soundness, which have not been shown, the Board believes that the choice of organizational structure should be left to management.

Fifth, we are also concerned that proposals which restrict and freeze service corporation activities for federal associations, without affecting state-chartered thrifts, would pose a threat to the dual chartering system for thrifts. This could result in a massive flight to the state charter in states that have liberal service corporation investment authority. A rush to very permissive state charters also has negative implications for the Federal Savings and Loan Insurance Corporation insurance fund. Such an imbalance should be avoided by preserving the current service corporation powers of federal thrifts.

Finally, preserving current service corporation authority for federal thrifts would not in any way create a competitive advantage over banks. Under the proposal being considered, banks would continue to have an array of subsidiary options -- such as operating subsidiaries and Edge Act and Agreement Act corporations -- which are much broader than the current service corporation options of federal thrifts. The competitive significance of the authority of federal associations to invest 3% of their assets in service corporations -- 1/3 of which must be for community, inner city, and community development purposes, is far outweighed by the continuing subsidiary activities available to banks.

RESTRICTING SAVINGS AND LOAN HOLDING COMPANY ACTIVITIES

Several legislative proposals before this Committee would amend the Unitary Savings and Loan Holding Company Act so as to provide roughly the same restrictions which would apply to commercial bank holding companies. From all appearances, the underlying justification for these proposed restrictions is founded on the faulty premise that thrifts and commercial banks are now essentially the same. And, as I discussed at length earlier, this is simply not so.

More than a decade ago, the Congress established a separate holding company structure which was unique to thrifts. This structure enables holding companies to conduct a diverse array of activities that lend strength to their subsidiaries and permit different types of companies to acquire thrifts. The greater diversity enjoyed by thrift unitary holding companies, when compared with bank holding companies, reflects the Congress' longstanding recognition of the need to supplement the limited asset authority of thrifts.

Before enacting the Garn - St Germain Act, Congress completed a review of the entire savings and loan holding company structure. By deciding to retain that structure in its present form, Congress -- just 12 months ago -- clearly reaffirmed its belief that the added flexibility provided by that format was, indeed, an appropriate supplement to the limited asset powers of thrifts. Thus, the only restrictions imposed by Congress on unitary holding companies were aimed at ensuring the continued focus by the thrift subsidiary on the traditional home financing function.

The unitary holding company structure has worked well to date and serves as an important source of capital infusion to the industry, by enabling holding companies to conduct a diversity of activities that lend strength to their subsidiaries, and by permitting different types of companies to acquire thrifts. As the chief federal regulator of the savings and loan industry, I have seen no evidence, despite considerable inquiry on my part, that the current unitary holding company structure has led to abuses that would warrant the kind of significant legislative change being proposed to this Committee.

Opponents sometimes point to the greater diversity enjoyed by thrift unitary holding companies when compared with bank holding companies. However, at the risk of being redundant, this difference specifically reflects Congress' longstanding recognition of the need to supplement the limited asset authority of thrifts and of the fact that, because of the limited commercial asset powers of thrifts, ownership does not raise the credit allocation issues present in the ownership by commercial banks of commercial enterprises. Given these differences, we can see no basis for emasculating unitary savings and loan holding companies by replacing their current flexibility with a "laundry list" of activities -- to be determined by a commercial banking regulator -- which is designed to be the rough equivalent of bank holding company and multiple savings and loan holding company authority. There is no justification for this change, if the goal is to truly balance the authorities of the bank and thrift industries.

Under legislative proposals now before the Committee, when the savings and loan holding company provisions are combined with the proposals to reduce thrift service corporation powers, two things become very clear. First, thrifts would be stripped of diversification options crucial to industry health. They would be left with a single operating-type subsidiary in which they can invest only 3% of assets, and only if they maintain their mutual form. Simultaneously, bank holding companies will have received an enormous expansion in power. And banks will have retained a host of subsidiary powers in which their investment is potentially unlimited.

If there is evidence to show that there have been abuses which would warrant a dramatic reshaping of thrift holding companies, I would like to be told about them. The Bank Board can see absolutely no basis for proposals to limit the real estate investment authority of holding companies to a level below that which multiple holding companies and thrift service corporations are permitted to invest and have safely invested in, for decades. Moreover, a proposal which would limit holding company investment in such ventures to a 5%-of-capital "cap" -- while grandfathering only specific projects existing on July 1, 1983, would eliminate real estate investment and development as economically significant activities for thrift holding companies. And because multiple S&L holding companies now can invest an unlimited amount in real estate development, such a change means that even existing multiples would lose very substantial rights.

While involvement in real estate may present certain risks, they are far less than those connected with new securities activities that would be authorized -- without investment limitation. It makes no sense to us to limit real estate investment and development -- fields in which thrifts have substantial knowledge, experience and success -- while opening the door to potentially riskier securities activities that depository institutions generally have not previously been permitted to conduct.

The Board is also very concerned about legislative restructuring that would require formation of a holding company in order to conduct new financially-related activities through holding company affiliates, rather than through service corporations. Efforts to force activities into holding company affiliates severely disadvantage the vast majority of the thrift industry, 77% which is in mutual form and must convert to stock form and then create a holding company structure to take advantage of these new powers. This is a costly and time-consuming process, and a discriminatory burden, especially when it comes to proposals which would permit banks and thrifts to conduct newly authorized securities activities _only_ through holding company affiliates. This severely disadvantages mutuals -- _three quarters of the entire thrift industry_ -- in their ability to compete with banks in important new areas of financial services. Frankly, we are unable to see the wisdom of placing the thrift industry, in view of its current seriously fragile financial condition, at such a competitive disadvantage.

We also believe significant problems will result from the very limited nature of grandfathered rights and exceptions provided by the various permanent restructuring proposals for thrift holding companies. Basically, these legislative proposals would extend grandfather rights to existing unitary holding companies to conduct activities actually engaged in on a certain date. But these rights would lapse completely if a company engaged in virtually any new activities. In many cases, existing companies could not expand their businesses unless they divested their thrift subsidiaries. This could result in the loss of critical capital resources for thrifts.

In supervisory cases, the reform proposals generally provide that the restrictions on activities of existing and new unitary holding companies will not apply in a supervisory case falling within Section 408(m) of the National Housing Act. But this authority ends completely on October 15, 1985. Thus, the FSLIC would in many cases, be helpless to avert failures which would result in serious consequences to the integrity of the fund. This sort of thing can be avoided if continuing authority is provided to the Bank Board to seek certain kinds of non-depository acquirors for weak institutions.

Clearly, scaling back the options of thrift holding companies in such a drastic way as has been proposed in legislation before you will make thrifts far less attractive to the capital markets and to investors. Any reduction of thrift asset powers, or a significant diminution of structural flexibility, would seriously undermine the ability of thrift institutions to generate counter-cyclical earnings streams to offset interest rate swings. Given the Congressional mandate that thrifts maintain their commitment to housing lending -- which continues to involve primarily long-term fixed-rate credit -- thrifts, unlike banks, are therefore uniquely susceptible to the dangers of interest rate risk. By depriving thrifts of important asset powers and structural "elbow room" to balance their portfolios, especially in the service corporation area, proposals before the Committee would have the effect of driving thrifts toward the same asset/liability mismatch trap that nearly proved fatal to the industry during the last several years.

And, I have already noted, reduction in the structural flexibility of thrifts diminishes the value of a thrift charter. This could impede the valuable mutual-to-stock conversion process, or, at the very least, diminish the amount of capital that may be raised in conversions.

We believe such changes could translate into a "domino" effect of negative consequences for the industry: reduced capital invested, leading to lower thrift net worth, increased pressure on the FSLIC insurance fund, and increased federal expenses to stave off failures. We believe such results must be avoided by leaving the current powers of thrift holding companies -- and service corporations -- intact.

EROSION OF BANK BOARD AUTHORITY

One of the least desirable of the options you are reviewing is the proposal to shift responsibility for determining the new activities of a savings and loan holding company from the Bank Board to the Federal Reserve Board. This agency has carried out conscientiously its responsibilities without significant controversy for a great many years, and we believe there is absolutely no justification for seeking such a diminution of the regulatory responsibility Congress has conferred upon the Bank Board during the last half century. A uniquely comprehensive set of regulatory empowerments was a central factor in the ability of our agency to cope with the ruinous negative earnings period from which we are now apparently only beginning to emerge. To start dismantling that proven structure would be to act without any basis in sound policy. Moreover, at a time when we are supposedly concerned with reducing the burden of federal regulation, it strikes me as strange to begin increasing the number of mainstream regulators with which thrifts must contend at the federal level. I strongly urge you to reject this effort to erode the ability of our Agency to deal effectively with our regulatory responsibilities.

In this context, let me comment briefly on the variety of proposals made over the last several years that would consolidate the various federal agencies which regulate financial institutions into one or two "super" agencies which would regulate, or even insure, both commercial banks and savings and loans institutions. The underlying rationale for these proposals is often that banks and thrifts are essentially similar and should be regulated in essentially the same way. As I have already made clear, I do not agree.

This is not simply a turf issue. Combining commercial banks and thrifts under the same regulatory umbrella would add substantial credibility to the notion that the public policy purposes of thrifts are no longer truly distinct from those of commercial banks. I strongly believe that it is in the public interest to maintain an entirely separate regulatory structure for thrifts so long as the Congress determines that the fundamental role of these lending institutions should remain distinct from that of banks.

From the point of view of administrative efficiency, I believe -- and I believe many objective observers agree -- that the Bank Board structure has performed well through the years. I seriously doubt that a different regulatory agency -- with different regulatory and assistance tools and a broader jurisdiction -- could have dealt as successfully as the Bank Board did in managing and steering the thrift industry through the recent crisis.

THE INVESTMENT BANKING ISSUE

Despite the Bank Board's opposition to proposals that reject the positive approach to unitary savings and loan holding companies taken by the Garn-St Germain Act, there is one type of affiliation -- and one type only -- which raises significant concerns in our minds.

I am specifically referring to the merger of investment banking -- that is, securities underwriting -- with depository banking. I am not referring here to stock brokerage but rather stock underwriting. The combination of investment and depository banking, has been recognized, over the years, as presenting unique potential for conflicts of interest and risk. As the Supreme Court pointed out over a decade ago, the competition, convenience, and expertise which might otherwise support the combination of depository and investment banking activities, were outweighed by the hazards and financial dangers that arise when depository institutions combine with investment banking firms.

Until recently, securities underwriting firms generally showed no interest in acquiring thrifts. Now, however, such firms have reoriented their thinking about deposit-gathering, given the successful experience of the securities industry with money market mutual funds.

In addition, today, affiliations between investment banking firms and institutions that enjoy federal deposit insurance raise new concerns and unanswered questions about the role and risk to deposit insurance funds posed by such alliances.

I do not believe that I or anyone can predict all of the problems that could arise through the combination of depository institutions and investment banks. However, at least several types of problems are possible.

Investment banking firms owning a depository institution, and engaged in the underwriting of the stock of other depository institutions, could obtain confidential information about actual or potential competitors.

Under different circumstances, an investment banking parent firm might attempt to unload undesirable securities through its affiliated depository institution, leading to a loss of public confidence in a depository institution if investments purchased through its auspices turn sour.

Similarly, depository institutions might attempt to extend credit imprudently to individual customers in order to facilitate purchases of stock marketed by the investment banking firm, or might be tempted or coerced to make investments in securities underwritten by an investment banking affiliate.

Also, some transactions between investment banks and depository institutions can create public policy problems -- even without a direct ownership relationship between them. For example, as you know, the brokering of insured deposits through securities firms can allow very frail depository institutions to expand quickly and dramatically, with both the broker and the depositor knowing that it is the FDIC or the FSLIC, not themselves, who bear the consequent risk. Funnelling of deposits through brokers -- often at above market rates -- presents safety and soundness concerns from both the perspective of the depository institution involved and from that of the federal insurance funds.

The fundamental purpose of FSLIC deposit insurance has been, for a half century, to insure deposits which could then be used primarily by thrift institutions for home mortgage lending.

Therefore, I question, philosophically, to what extent the limited resources of the federal deposit insurance system should serve as a guarantee for financial instruments developed and marketed by securities firms. The magnitude of those transactions -- and the risks and policy questions they raise, are likely to be exacerbated, in our view, when an investment banking firm owns its own thrift. Further, we see an important legislative policy isssue emerging, which the Congress may indeed wish to consider. Should a money broker be free to ignore the consequences of its actions in placing substantial levels of high-cost funds in an insured depository whose financial condition may be further jeopardized by such actions -- to the ultimate detriment of both the institution and the federal deposit insurance funds?

These are key issues which may indeed be relevant to the implications of deregulation in today's financial services environment.

We are not saying that we believe that all the issues and potential problems we have cited would necessarily arise -- simply that they could. As fiduciaries of the FSLIC and as regulator of the thrift industry, these issues give cause for legitimate concern. In particular, given the present fragile financial condition of the thrift industry, we would question the wisdom of introducing new risks prompted by these serious concerns into the industry at this time.

Therefore, despite the Board's general and strong opposition to proposals that seek to turn back the clock on the flexibility of thrift unitary holding companies -- reaffirmed less than a year ago in the Garn-St Germain Act -- we believe the issue of possible combinations of investment banking firms and thrifts may well warrant appropriate consideration by the Congress as it relates to the Unitary Savings and Loan Holding Company Act.

Our concern with regard to this issue applies both to affiliations between investment banking firms and healthy thrifts -- and perhaps even more so to thrifts in supervisory situations. While present law does provide the Bank Board with standards under which the Board could deny applications by investment banking firms to acquire and operate thrifts, the unique risks presented by the combination of depository and investment banking may merit the sort of attention by the Congress to which I have alluded.

In summary, while the Federal Home Bank Board opposes a complete moratorium on holding company acquisitions of thrifts, as has been proposed by some, we do believe the Congress should carefully and deliberately consider the extremely serious implications of widespread acquisitions of depository institutions by securities underwriting firms and take the actions it deems appropriate to address this major issue.

* * * * *

Again, I appreciate the opportunity to appear before you and I will be pleased to answer any questions the Committee may have.

THRIFTS MAIN PURPOSE IS RESIDENTIAL MORTGAGE LENDING

The CHAIRMAN. Thank you very much. You have commented at great length on the issue of whether thrifts are now banks, and obviously Garn-St Germain last year granted thrifts a lot of new powers and broadened and balanced thrifts' portfolios. Much is said day after day about banks or thrifts becoming more like banks. One analysis that an analyst recently wrote, and I quote, "If it looks like a bank, smells like a bank, and acts like a bank, then it is probably a thrift." Many small bankers look at thrift portfolios now and come to that same conclusion. On pages six and seven of your statement you want into quite a bit of detail about why thrifts are different. I still believe they are different. They still have many, many limitations on their assets—certain percentage in this basket and another percentage in that basket. There are still a lot of great differences. My question is: To what extent have the thrifts, since the bill became law last October 15, been using their new powers? Do you have any figures or information?

Mr. GRAY. Well, I would mention one thing, at our last look, at year-end 1982 roughly 86 percent of the qualifying assets of S&L's were in residential mortgages, which I think speaks for itself. I would go further and point out that in the month of June the savings and loan industry made mortgage loans amounting to $13.4 billion, the largest monthly amount in the history of industry, which certainly indicates that, insofar as mortgage lending is concerned, these institutions continued to remain in that. And I would suggest that they remain in it to a far, perhaps almost infinitely greater degree than commercial banks.

[Letter indicating a change in figure regarding thrift mortgage lending follows:]

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 26, 1983

Honorable Jake Garn
Chairman
Committee on Banking,
  Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am delighted to update for you the preliminary figures I referred to in my oral remarks before the Committee on September 13, regarding thrift mortgage lending in June. At the time I appeared before your Committee last week, our preliminary estimates showed that FSLIC-insured associations made mortgage loans of $13.4 billion in June, a record monthly amount. Our final figures show the amount was actually larger: $13.85 billion in mortgage loans were made by FSLIC-insured thrifts in June. The figure for mortgage lending by all operating associations was slightly higher, at $14.1 billion.

These final figures further strengthen my conviction, as I stated to the Committee last week, that thrifts continue to remain heavily committed to mortgage finance.

Sincerely,

Edwin J. Gray

I would like to point out—since there are only two members of this committee present, that this chart indicates very clearly the difference in asset authorities for commercial banks as represented by the red bars, and asset authorities of thrifts, which are represented by the blue bars. The options that a thrift has to use on the asset side of the ledger are severely limited in any comparison that can be made with commercial banks.

The CHAIRMAN. Well, it is your feeling that it is the intention of the thrift industry to continue to primarily emphasize mortgage lending?

Mr. GRAY. Yes, it is. I think there are adequate incentives already built into the law, incentives which have basically been in the law for many years, to encourage thrifts to remain in primarily residential mortgages. The tax treatment itself, with respect to the bad debt deduction requires that, as well as the qualifying assets test established in Garn-St Germain for using powers related to branching and unitary holding companies. I see no evidence in a continuing overview of the activities of the thrift industry, particularly in light of the record mortgage activity in the month of June, that I emphasize as a case in point, to show that there's any basic change in the kinds of things Federal S&L's are doing and, in fact, want to do in the future, because that's where their expertise, built up over a long period of time, resides.

The CHAIRMAN. Well, that's very interesting. Sitting at that very witness table, 1½ to 2 years ago, we had the arguments made over and over again by homebuilders, and realtors, and others—if we granted the thrifts the 10 percent commercial authority, that they would become banks and the source of mortgage credit would dry up, even though members of the U.S. Savings and Loan League, and others were sitting at the same table and saying, look, our expertise is in mortgage lending. We have a liquidity problem, we have a short-term problem we need to solve, we need to have more flexibility in our structural operations, but we will continue to stay in the mortgage lending business. I can remember making that comment many times, because at that period of time, there were virtually no mortgage loans being made. There were institutions, thrift institutions in my State, that hadn't made a mortgage loan of any kind for 2 years. So my point was that yes, it would diminish that activity somewhat, but if they went down from their traditional levels 70, 75, 80 percent—if they dropped to 50 percent—that 50 percent was a lot better than nothing, to make the point that they simply weren't in the mortgage lending business. And I felt, frankly, that it would drop, considerably. It's only been a year, but I am frankly surprised at the high level of mortgage lending that has been maintained, just about the same as the traditional level. So at least in that testimony, they meant what they said. They wanted to stay in the mortgage lending business. I think the only thing that would deter them again is not the changes of the type we made, but high interest rates. They got caught back in the same old trap of borrowing short and lending long, because that's what caused the problem to begin with. So it's my own opinion, granted, on the basis of only a year of experience, that the thrifts will stay in the mortgage lending business if we get a more fundamental problem under control, that is the economy and budget deficits. If we can get back down to even 10 or 11 percent mortgage rates—it would be incredible, the amount of money being loaned and the boom in the homebuilding industry.

Mr. **Gray**. I think some of this confusion may originate on the liability side—the ability of thrifts to access funds for home mortgage lending is somewhat similar to that of banks. There are differences, but it's somewhat similar. On the asset side, there is a fundamental difference, given the longstanding expertise of thrift institutions, and the housing mission already built in the law, and reaffirmed under Garn-St Germain. These institutions, indeed, are going to continue to concentrate on mortgage lending. But I would also point out that the Garn-St Germain bill provided limited new asset powers to help thrifts address their asset liability maturity mismatch so they could continue their primary mortgage lending role—given the impotence at the time—because of rates—of the thrift industry to make a significant volume of mortgage loans. And even with commercial lending authority now, up to 10 percent of assets for Federal thrifts—the fact is that this industry is not familiar with commercial lending. And it will take, I think, a good deal of time for the industry to move into that to any substantial degree at all.

THRIFT INDUSTRY OPPOSES TREASURY AND MORATORIUM BILLS

The **Chairman**. While members of the thrift industry are opposed to at least portions of the Treasury bill, they feel it's unfair to thrifts because it lumps thrifts and banks more together; that is their feeling. Is that what you are hearing from the industry?

Mr. **Gray**. Yes. They are very concerned. There's no question about it. I would say that from all of the indications that I have received, the thrift industry actually would much prefer to not be a part of this bill, given the fact that over an 18-month period, that Congress deliberated in a very comprehensive way on the problems of thrifts, both their short and longer term problems, and came up with what I think and what certainly the thrift industry believes, is a definitive basis for enabling them to survive in the future.

The **Chairman**. At a recent meeting the FDIC voted to conduct regular examinations of federally chartered savings banks. The justification was that the Federal Home Loan Bank lacked the manpower to conduct the examinations. The report language of the act indicated that the Bank Board is to regulate those banks.

Do you think the FDIC is complying adequately with the statute in conducting examinations, or on what basis should the FDIC conduct examinations?

Mr. **Gray**. Well, I think that the legislative history of the Garn-St Germain Act makes clear that the Federal Home Loan Bank Board should continue to be the primary examiner, in terms of regular examinations. Clearly, the FDIC can engage in special types of examinations, depending on the need that it feels. But we believe that the Federal Home Loan Bank Board, as I have indicated in a letter to you, Mr. Chairman, and to the chairman of the House Banking Committee, should have primary regulatory jurisdiction.

The **Chairman**. I have just received it as you were talking.

Mr. **Gray**. I think the letter makes clear our position, which essentially is that the legislative history of the Garn-St Germain bill, and negotiations which ensued at the time, indicate that the national banks and those thrifts which would be insured by the FDIC, should be examined in a consistent way, together, rather than just singling out one kind of institution.

The **Chairman**. I would ask, Mr. Chairman, that a copy of your letter to Hon. William Isaac and your letter to me be included in the record at this point to explain fully your answer to my question.

[The following was subsequently submitted for the record]

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 9, 1983

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
SD-534 Dirksen Office Building
Washington, DC 20510

Dear Mr. Chairman:

For your information, I am forwarding a copy of my September 9, 1983 letter to Chairman Isaac regarding the FDIC decision to subject Federal savings banks insured by that agency to regular periodic FDIC examinations.

In adopting the Depository Institutions Act of 1982 (the "Act"), the Congress expressed its clear intent that the FDIC treat Federal savings banks the same as it does national banks. It is our position that the FDIC's proposed action would not only contravene Congressional intent but also would go beyond the authority conferred by the Act. I am requesting the FDIC to reconsider its position and to adopt a posture consistent with the statute and the intent of the Congress.

I wish to take this opportunity to deny any public statements which Chairman Isaac or his staff may have attributed to the Federal Home Loan Bank Board regarding the ability of this agency to fulfill its obligations. For the record, we are ready, willing and able to perform all of the functions, including examinations, that the Congress assigned to us as the primary supervisor of Federal savings banks.

If you have any questions, or comments regarding this matter, I would appreciate the opportunity to discuss this with you personally.

Sincerely,

Edwin J. Gray

Enclosure

cc: Chairman William M. Isaac

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 9, 1983

Honorable William M. Isaac
Chairman
Federal Deposit Insurance Corporation
550 Seventeenth Street, NW
Washington, DC 20529

Dear Mr. Chairman:

In its statutory position as primary supervisor of Federal savings banks, the Federal Home Loan Bank Board must take exception to a recent decision of the FDIC to subject those banks that choose to retain FDIC insurance to an FDIC examination. Such action is not authorized by the Depository Institutions Act of 1982 (the "Act"). The legislative history of the Act makes clear that the intent of Congress was for the FDIC to treat Federal savings banks the same as it does national banks. Further, your proposed action does not conform to agreements made in this regard by representatives of our agencies both prior and subsequent to passage of the Act.

I am dismayed that the FDIC would take this action without any prior consultation with the Bank Board. Also of concern are the recent comments suggesting our agreement with your proposed examinations, which have found their way to the press and which are inaccurately attributed to this Agency.

While I personally regret the necessity to write you in this vein, as Chairman of the Agency, I cannot permit this matter to go unchallenged. Based upon our demonstrated record of regulation and examination of Federal savings and loan institutions, we stand willing and able to perform all of the functions, including examinations, that Congress assigned to us as the primary supervisor of Federal savings banks.

The many questions and comments we have received from both Houses of Congress, the press, and members of the thrift industry are a clear indication that this Agency is not the only entity surprised by and in disagreement with your proposed action. I strongly urge the FDIC to reconsider its action and to adopt a posture in line with the intent of Congress, i.e., that the FDIC afford Federal savings banks the same examination and supervisory treatment as it now affords national banks.

The Board and its staff are available for discussion on this or any other matter affecting Federal savings banks.

Sincerely,

Edwin J. Gray

cc: Honorable Jake Garn
Honorable Fernand St Germain

BEST COPY AVAILABLE

Mr. **Gray**. Yes. I would like to point out that we are not desirous of getting into some kind of squabble with the FDIC on this matter. We do believe, however, that there is substantial justification for the approach that we take for the primary examination process to be done by the Federal Home Loan Bank Board, and we are able to do that. We see that as our responsibility.

The **Chairman**. You were here, I noted, when I had my discussion with Chairman Volcker about the moratorium. What is your feeling about the Fed's moratorium bill?

Mr. **Gray**. Well, as I sought to indicate, perhaps not in as direct a way as I might have—we have had, from the time the moratorium proposal was first discussed—great opposition to it. We believe that the Congress really ought to come up with a permanent solution, because we are very concerned that a moratorium could stand indefinitely, perhaps for years. We do not believe that this would serve a constructive purpose. But beyond that, we are concerned that the initiative of another regulator would be translated into de facto regulation of our industry, by virtue of that moratorium. Therefore, we are opposed to the basic idea of the moratorium.

The **Chairman**. Senator Trible.

Senator **Trible**. Thank you, Mr. Chairman.

Welcome, Chairman Gray.

GREATER DIVERSIFICATION NEEDED TO STRENGTHEN THRIFTS

I think in your testimony you have correctly underscored the central question before us, and that is whether banks and thrifts are functionally equivalent, and thus ought to be treated alike or not. The Treasury bill assumes that thrifts and banks are basically the same and ought to be treated alike. And you have said that is not the case.

Could you review for me the basic asset powers of thrifts and tell us more precisely how they differ from bank assets?

Mr. **Gray**. I will make available this chart, but I think it says it very, very well, if we are talking about the asset powers of the thrift institution itself, apart from the holding company act, which I would, in this context, not refer to as an asset power, per se.

But in commercial lending, basically, banks have unlimited authority to invest up to 100 percent of their assets in this kind of activity. Federal savings and loan institutions however, can invest only 10 percent of assets in these loans. It will take a long time for them to begin to use that fully, if ever. On consumer loans, again, banks have 100-percent authority. Savings and loans have 30 percent. On equipment leasing, banks have 100-percent authority. Savings and loans have much less, 10 percent.

On secured nonresidential real estate loans, savings and loans have, again, in contrast, far less than commercial banks, and the same on unsecured nonresidential real estate loans.

The contrast is stark, if you really analyze it, and I am afraid that not very much analysis has gone into this. Perhaps a more close reading of the differences would be in order for those who have questioned me about it.

Senator TRIBLE. I think that's very helpful. I think it's necessary to underscore the distinctions that you have drawn between the asset powers of banks and thrifts.

You have also underscored, I think quite correctly again, the fragile state of thrifts: the potential impact of higher interest rates, the fact that thrifts are still making long-term fixed rate mortgage loans. As a result of that situation, shouldn't Congress be actively encouraging greater thrift diversification and granting wider authority to diversify to reduce the likelihood of some new crisis?

Mr. GRAY. I would hope that the sense of Congress certainly could be communicated either by individual Members of Congress or as a whole, that diversification, indeed, will help thrifts to more quickly recover their health.

Of course, we understand, as you point out, that the interest rates are a particular difficulty to these interest-rate sensitive institutions.

I, as Chairman of the Federal Home Loan Mortgage Corporation, recognize the public policy purposes that that corporation serves, and have encouraged thrift institutions to make better use of the secondary market. I don't think institutions are doing that, and that, of course, would enable them, to some substantial measure, to begin to bring into closer balance the maturities and durations of both assets and liabilities, which is a very big problem for thrifts.

As thrifts went into the 1980, 1981, 1982 period, the mismatch of assets and liabilities was really absurd. As a result, as interest rates went up, as the cost of money went up, many thrifts began to fail. I have taken it upon myself, in speech after speech around this country, to thrift industry executives, not only to encourage the greater emphasis on portfolio restructuring—I would also point out that various industry trade groups are doing the same thing—but to warn that unless thrifts begin to do this in a very deliberate manner, and start now to do it, the future cycle could indeed make the last cycle look like children's play. It could have devastating effects on the survival of the industry itself. But I do think that some progress is being made. I do see signs that more and more thrifts are beginning to recognize this. They certainly ought to, having gone through this terrible agony of the last few years. The lessons of history teach us a lot, and they certainly have been important lessons in that period. So I do see real emphasis on the part of many institutions to begin to restructure their portfolios, and in that regard to concentrate to a much greater extent on the adjustable rate mortgage as a means of bringing out that kind of match.

Senator TRIBLE. One way we can encourage or strengthen the industry is to encourage the conversion of thrifts from mutual to stock enterprises—obviously, a way to build up net worth and the total capital of the industry. Is there anything Congress can do to ease that conversion process?

Mr. GRAY. One of the things that the Congress could do would be to take strongly into account the proposals, or the observations I should say, that I have made with respect to the unitary company authority under the Savings and Loan Holding Company Act, to leave it substantially in place the way it is, as a supplement to the more limited asset powers of thrift institutions, vis-a-vis banks, bank holding companies and their authorities. We have at the Federal Home Loan Bank Board beefed up our support staff for conversions, and I think we are processing those applications very expeditiously now. Obviously, the level of interest rates has a direct impact on the kind of window that is open at any given time to facilitate the conversion process of thrifts, but we think that this is a very healthy development. And this is why I have emphasized, in my testimony, the need to protect the value of the thrift charter, particularly as it is perceived in the capital markets by investors, from being diminished, from losing its luster and glitter, because this is a magnet for investors wishing to make these conversions successfully. We have had $2 billion in new capital infused as a result of some 40 conversions thus far this year.

Now, obviously it's going to take a long time. The market can only accommodate so much of the conversion process at any given time. But we think over the long haul the law, as it presently exists in this regard, and the policies of the Federal Home Loan Bank Board which are in place, will encourage continued conversions.

Senator TRIBLE. Should thrifts be allowed to invest more than 3 percent of their assets in profitable service corporations as a means of strengthening thrift operations?

Mr. GRAY. Senator, the Federal Home Loan Bank Board, 1½ years ago, proposed, as I recall, that Federal thrift service corporation activities be increased to a level of 5 percent, and that the permissible activities be expanded. I think the Congress has spoken rather definitively about its desire to keep the level at 3 percent in the legislative history of Garn-St Germain. And we are basically satisfied, as a result, that 3 percent, at least as of now, is sufficient for these institutions to bring about a major diversification. That standard resulted from a good deal of input in the legislative process. We are happy with what we have. Perhaps we would like more, but the legislative process, it seems to me, has dictated the will of Congress in that regard, only a year and a half ago.

Senator TRIBLE. Well the glory of this process, Mr. Chairman, is legislative process is an ongoing one? It never ends.

Mr. GRAY. I would like to say, however——

Senator TRIBLE. To that end, I wanted to give you an opportunity to build a record.

FED REGULATORY AUTHORITY SHOULD BE REDUCED, NOT EXPANDED

Mr. GRAY. Well, I appreciate that. This is what I wanted to point out, as I tried to do emphatically—as I did in my written testimony—that there is a vital need for continuing Federal thrift service corporation authority, as it now exists in the law—and to preserve it from being compromised under legislative proposals before you. It is crucial that that authority, indeed, remain in place, and that it not be compromised or altered in any way. Our data shows that the service corporations have contributed very effectively to the bottom line of thrift institutions. In 1981, and 1982, when the thrift industry was losing $6 billion in net worth, service corporations in those years provided $211 and $157 million in positive contributions to the bottom line of thrift institutions, which indicates to me that they are, indeed, very important profit-generating centers for thrift institutions.

Senator TRIBLE. With the indulgence of the Chair, I would ask just one further question. A basic assumption, in your presentation today, is that we ought to have a specialized thrift institution or industry in order to meet our housing requirements. Let me be the devil's advocate for a moment and give you an opportunity to expand on that theme. In view of the fact that other financial institutions are now entering mortgage origination and considering S&L's, are increasingly selling their mortgages in the secondary markets, why is it necessary to have specialized thrifts to do this job? If the activity is a profitable one, why won't others enter and provide these kinds of services?

Mr. GRAY. Well, to the extent that there is an involvement in many quarters, in encouraging mortgage lending and home ownership, I think that's good. As a matter of public policy, thrifts, over a half century, I think, have made very substantial contributions to making this country one of homeowners. In fact, I think the Federal Home Loan Bank System and thrift institutions, themselves, are responsible, more than any other factor that I can think of, for making this contribution to homeownership. That has come as a result of the encouragement of successive Congresses over that time period.

I see nothing there, despite the activity of other sectors, getting into housing—that ought to preclude thrifts from continuing as specialized depository institutions to fulfill their basic mission, because thrifts are very excellent originators of mortgages. The mere fact that, in June, thrifts originated $13.4 billion in mortgage loans would tend to support that, I think, very strongly. So I see, nothing at all which would support a reduction of thrift authorities to accomplish this important public purpose.

Senator TRIBLE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Trible. I understand Congressman St Germain, chairman of the House Banking Committee, has written a letter to you wanting to know what action you intend to take on brokered accounts or brokered deposits. This caused a lot of losses, as you well know, from S&L's and credit unions in the Penn Square Bank failure. Do you have any general plan for regulating these types of deposits?

Mr. GRAY. We could point to some horror stories ourselves, or potential horror stories waiting to happen. We are concerned that money brokers, at present, can place these funds in institutions without any consideration whatsoever of either the health of the institution or, for that matter, without any consideration of possible impact on the FSLIC. We do have real concerns, and I have asked the staff to study in depth the problems that are, or could be associated with, the use of brokered funds. And we expect and will be delighted to forward to you our findings once the Board has an opportunity to look at that and make some recommendations.

Because we are not absolutely sure at this time of what our findings would show, it would be premature to suggest that legislation might be in order. But if our studies show that there might be a way to bring about greater responsibility on the part of many brokers in terms of the health of institutions where they place funds and, very importantly to mitigate the impact on the FSLIC, and we find then that legislation would be in order, we would be happy to provide a draft.

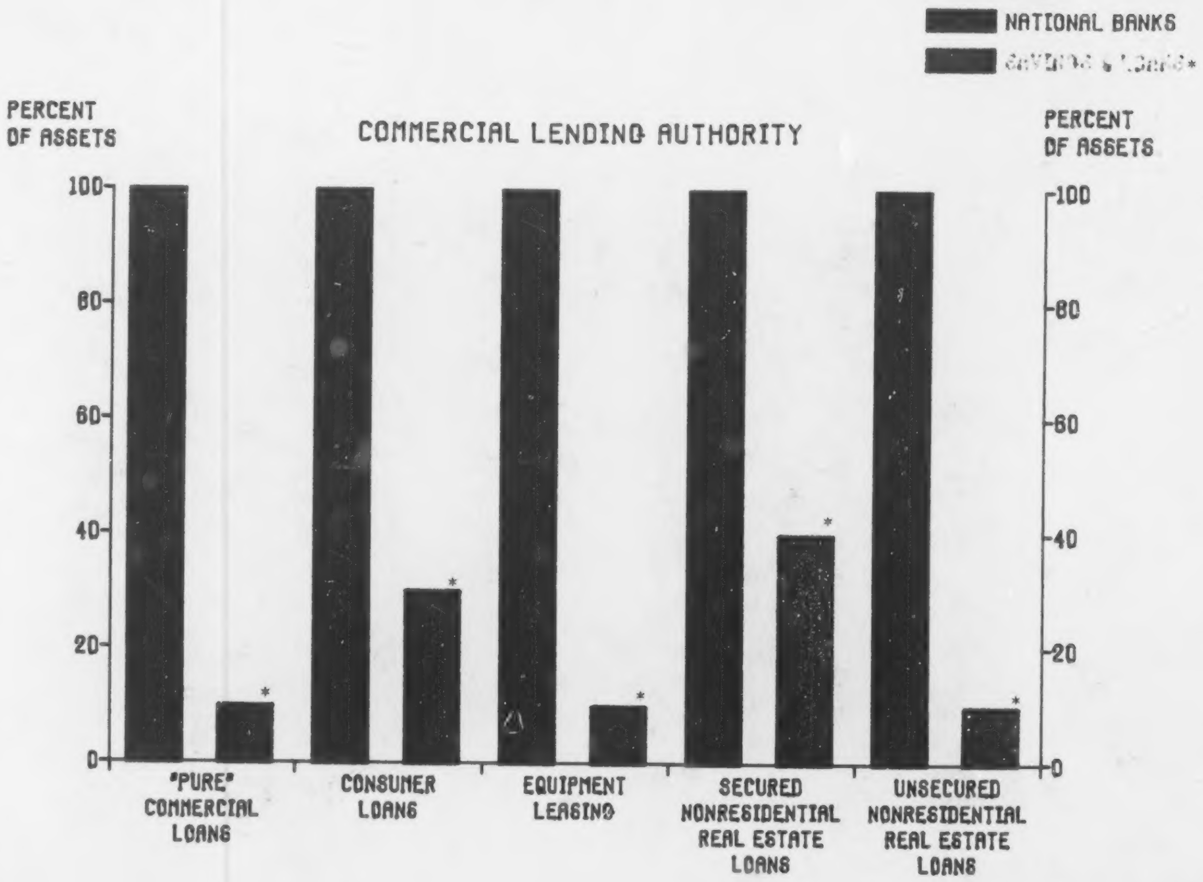
The CHAIRMAN. Federal Reserve is proposing to change their regulation Y dealing with the definition of commercial loans to anything that is not a personal loan. Now, this could bring thrifts and nonbank banks under the Fed jurisdiction. Can you comment on the Fed's proposal to change regulation?

Mr. GRAY. I am not familiar with that proposal, Mr. Chairman, but I would say that anything that would bring the Federal Reserve Board into the regulatory process over these distinct types of institutions would be of great concern to us. The Congress, in its wisdom over these many years, has allowed the Federal Home Loan Bank Board to regulate thrift institutions. I think that model has served the country well. This is why any proposal allowing the Fed to determine permissible activities for savings and loan holding company affiliates, and any other kind of thrift activity, would concern us. And I think it would certainly be of concern to the industry, but I can't comment specifically on that proposal, because I am not familiar with it.

The CHAIRMAN. The Fed has a hard enough time trying to decide what to do with their monetary targets. My own opinion is when we start looking at regulatory consolidation, it seems to me one of the first places you look is reducing the Fed's regulatory functions, not expanding them. Because their role, very seriously, should be, primarily, conduct of monetary policy. When we start talking about proposals like may be coming from Vice President Bush's task force, it seems to me their regulatory function should be reduced rather than increased.

Mr. Chairman, I would like to have you make your charts available so they can be included in the record on bank assets versus S&L asset powers.

[The following chart was supplied for the record:]


NATIONAL BANKS
SAVINGS & LOANS*
PERCENT OF ASSETS
COMMERCIAL LENDING AUTHORITY
PERCENT OF ASSETS
100
80
60
40
20
0
*
"PURE" COMMERCIAL LOANS
CONSUMER LOANS
EQUIPMENT LEASING
SECURED NONRESIDENTIAL REAL ESTATE LOANS
UNSECURED NONRESIDENTIAL REAL ESTATE LOANS

I do have additional questions for the record that I would like you to answer.

[Response to questions can be found on p. 254.]

RESPONSE TO INQUIRY OF SENATOR GARN FROM EDWIN J. GRAY

Question: On page 21 of your statement, you point out that requiring thrifts to form holding companies puts mutual thrifts at a disadvantage because they must convert to stock form to form holding companies. On page 23, however, you argue that the mutual-to-stock conversion process is valuable, because conversions to stock attract capital. Can you reconcile these statements?

My belief that the mutual-to-stock conversion process is a valuable one for the industry is in no way inconsistent with my view that compelling mutuals to convert to stock form -- in order to take advantage of powers available only to holding companies under certain legislative restructuring proposals -- would create severe problems for the mutual segment of the industry. Requiring such conversions would deprive management of vital discretion to choose the organizational form best suited to a particular institution, as well as the ability to choose optimum timing when a conversion is deemed beneficial.

We are acutely aware that the industry's net worth base was severely depleted during the 1980-1982 period. Due to high and volatile interest rates and the statutory "straitjacket" which prevented thrifts from balancing their asset-liability maturities, there is a crucial need for recapitalizing the industry. Obviously, the conversion process offers one promising avenue at present to recapitalize. Nevertheless, the Board believes that it would be totally inappropriate to compel institutions to undertake conversions. Our policy is to allow management to make the final decision, given the numerous and complex factors which must be considered when determining whether conversion would be beneficial. Perhaps most important, while the Board has taken a number of steps to reduce the costs and timing of the process, conversions represent major corporate reorganizations and necessarily involve time and money to accomplish. Additionally, management must carefully evaluate likely investor interest at the time of the offering in view of perceived interest rate risk affecting the thrift's portfolio, present and projected earnings, portfolio strength, customer base, the need or lack of need for capital improvements or expansion, such as the installation of additional electronic terminals, and the additional administrative cost related to regulation of issuance and trading of securities. Moreover, many mutuals are reluctant to convert to the stock form for fear of hostile takeover. The Board staff is now considering a number of options to allay these fears.

Finally, even assuming that the mutual segment of the industry universally opted for conversion and a holding company structure, the process could not take place overnight. Many institutions therefore could not immediately form holding companies, and would be placed at a competitive disadvantage. Currently, roughly 77% of all federally insured associations -- approximately 2,500 thrifts -- are in the mutual form. Even with the Board's efforts to speed up the conversion process, only 34 thrifts converted in 1982, and about 50 have occurred so far in 1983. It would be mechanically and economically impossible for 2,500 associations to convert to stock form in the immediate future.

The Bank Board, as a regulator, will continue to encourage the industry to convert to the stock form. However, in my view, federal intervention to accomplish such result on a wholesale basis -- by forcing thrifts to choose either a disadvantageous conversion or the loss of competitive efficiency -- would be extremely counterproductive.

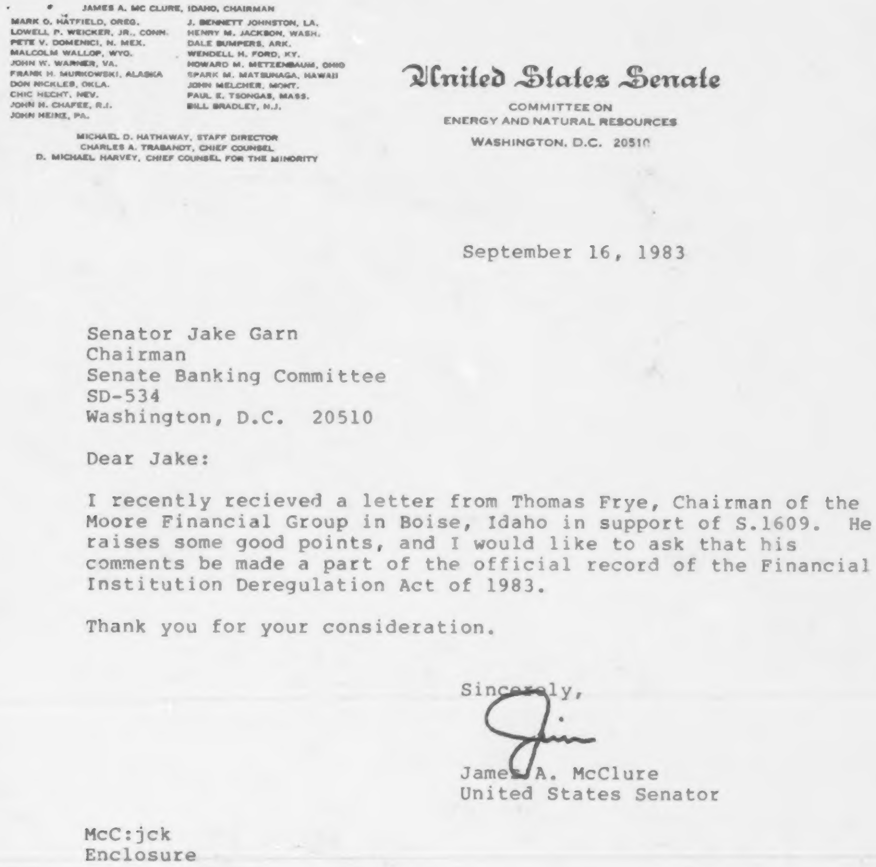
I believe this is your first appearance before the committee since your confirmation. I still believe the President made an excellent choice. I am happy to have the opportunity to work with you, and thank you for your testimony today.

Mr. GRAY. Thank you, very much.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]



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HOWARD M. METZENBAUM, OHIO
SPARK M. MATSUNAGA, HAWAII
JOHN MELCHER, MONT.
PAUL E. TSONGAS, MASS.
BILL BRADLEY, N.J.

MICHAEL D. HATHAWAY, STAFF DIRECTOR
CHARLES A. TRABANDT, CHIEF COUNSEL
D. MICHAEL HARVEY, CHIEF COUNSEL FOR THE MINORITY

United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, D.C. 20510

September 16, 1983

Senator Jake Garn
Chairman
Senate Banking Committee
SD-534
Washington, D.C. 20510

Dear Jake:

I recently recieved a letter from Thomas Frye, Chairman of the Moore Financial Group in Boise, Idaho in support of S.1609. He raises some good points, and I would like to ask that his comments be made a part of the official record of the Financial Institution Deregulation Act of 1983.

Thank you for your consideration.

Sincerely,

Jim

James A. McClure
United States Senator

McC:jck
Enclosure

MOORE FINANCIAL GROUP

August 30, 1983

Senator James A. McClure
United States Senate
Washington, D.C. 20510

Dear Jim:

On behalf of Moore Financial Group Incorporated, I urge you to actively support the passage of S. 1609, cited as the Financial Institution Deregulation Act of 1983 (FIDA). If enacted, the FIDA would affect, in a fundamental and positive way, the ability of an Idaho-based institution to compete effectively in the financial services marketplace.

Legislation seeking to maintain the status quo in the financial services industry benefits neither the customer nor the industry and should not be supported. Rather, comprehensive legislation addressing the economic issues underlying the explosion of financial service providers must be proposed and passed. To that end, FIDA, or any comprehensive federal statute affecting financial institutions, should resolve the following:

*All federal barriers should be removed for interstate commerce activities by any provider of financial services, including depository institutions.

*In order to compete effectively in the marketplace, any affiliate of a depository institution holding company should be governed by and be able to rely on the rules governing like institutions in the jurisdiction in which the affiliate is located.

Thank you for your consideration of the merits of this legislation.

Yours very truly,

Tom

Thomas C. Frye
Chairman

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Idaho first
The Bank

IDAHO FIRST PLAZA
PO BOX 8247
BOISE IDAHO 83733

BEST COPY AVAILABLE

MOORE FINANCIAL GROUP

August 30, 1983

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United States Senate
Washington, D.C. 20510

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MORATORIUM LEGISLATION AND FINANCIAL INSTITUTIONS DEREGULATION

WEDNESDAY, SEPTEMBER 14, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee), presiding.

Present: Senators Garn, Heinz, Gorton, Hecht, Trible, Proxmire, and Sasser.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order. We are continuing the third day of hearings on S. 1532, S. 1609, and S. 1682 dealing with moratoriums on acquisitions and financial institutions deregulation. We are happy to have as our first witness this morning the Honorable William M. Isaac, Chairman of the Federal Deposit Insurance Corporation. Bill, we are happy to have you with us this morning. If you would like to proceed.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Thank you, Mr. Chairman, Senator Proxmire. If I could request to have my entire statement placed in the record so that I might just summarize it.

The CHAIRMAN. Well, we will have a little debate on that and decide later by vote. We will be happy to put your statement in the record.

Mr. ISAAC. Considering that the alternative is that I read the whole thing.

Senator PROXMIRE. It doesn't take as long if you read it all.

[The complete statement follows:]

STATEMENT ON

S. 1609, FINANCIAL INSTITUTIONS DEREGULATION ACT AND RELATED MATTERS

PRESENTED TO

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 a.m.
Wednesday, September 14, 1983
Room 538 Dirksen Senate Office Building

Mr. Chairman, members of the Committee, thank you for giving us this opportunity to present our views on S. 1609.

The FDIC is a strong proponent of deregulation in the financial services area. Many of the current restrictions on competition were enacted 50 years ago. Whether or not they were appropriate then, they no longer benefit the public nor are they necessary to the maintenance of safety and soundness in our financial system. We are also convinced that our regulatory structure and our deposit insurance system are in need of substantial reform. Limited, stop-gap measures, such as the proposed moratorium legislation, are not what is needed now. What is called for is comprehensive legislation that addresses head-on the structural, competitive and regulatory anomalies in the current financial services picture. We recognize the magnitude of this undertaking, and we assure you of our full and continuing support and cooperation.

Enactment of S. 1609 would be a significant step in modernizing laws affecting our depository institutions. It recognizes the many changes that have occurred in our financial markets and the need for our depository institutions to be freed from many legal, but no longer useful, barriers. It also addresses in a limited way the need for uniformity in the regulation of financial institutions by recognizing the desirability of functional regulation.

We have, however, some specific concerns about S. 1609. First, we object to the requirement that the expanded activities be conducted through a bank holding company affiliate. We see no reason to force people to incur the expense of forming a holding company -- indeed, thrifts organized in mutual form may not be able to realistically do so. The purposes of requiring a subsidiary are to insulate the bank from risk, assure uniform regulation, and provide for separate capitalization and funding. We support those purposes. All of them can be achieved through a bank subsidiary just as effectively as through a bank holding company subsidiary. Moreover, to better insulate the bank itself, we would consider strict limits on the use of common names and logos and interlocking officers and directors, which S. 1609 does not do.

The principal reasons we are urging that depository institutions be given expanded powers are to provide a broader range of financial services to the American public at more competitive prices and to enhance the earnings of banks and thrifts. Why, in view of the latter objective, should we require that the subsidiary be structured so that the profits generated from bank customers flow to the holding company, not directly to the bank, and so that the capital base of the subsidiary directly protects holding company creditors, not bank depositors? We submit no sound rationale has been offered for such a requirement.

Second, we are concerned about the provisions of Section 10 of the bill, which would authorize bank holding companies to engage in insurance underwriting and brokerage without restriction and would authorize real estate brokerage and real estate investment and development, subject to a limit of five percent of capital. In our judgment, brokerage of both insurance and real estate -- and securities, for that matter -- is clearly a financial service that entails virtually no risk. It should be permitted for banks and thrifts as well as their holding companies or in subsidiaries of either.

Underwriting insurance and securities and real estate investment and development clearly involve greater risks. Accordingly, we believe that organization of these activities in a separate subsidiary should be required and that other safeguards, such as separate capitalization and funding requirements, should be imposed.

It should be recognized that permitting affiliations among banks, insurance companies, investment banking houses and real estate developers represents a substantial departure from the *status quo*, and raises a number of issues and potential problems, some of which are anticipated in S. 1609, some of which may not be. The FDIC recently commenced a rulemaking proceeding to gather information and public comment on bank involvement in these various areas. We will be pleased to share the results of this effort with the Committee.

Although we are proponents of well-conceived deregulation, some aspects of S. 1609 are difficult to rationalize. For example, why is real estate investment limited to five percent of capital, particularly when insurance underwriting has no limits at all? Why should banks be permitted to affiliate with a casualty insurer but not an underwriter of corporate securities?

Another related matter requires attention. The Glass-Steagall Act as currently written prohibits affiliations between securities underwriters and member banks but not nonmember banks or S&Ls. Although the FDIC has pending a second rulemaking proceeding to consider some regulation of securities activities by nonmember banks, there nevertheless remains a substantial competitive inequity among member and nonmember banks and S&Ls which S. 1609 fails to address.

Third, we endorse the concept of parity between unitary and multiple S&L holding companies and bank holding companies. As thrifts and commercial banks are clearly in competition today for both deposits and loans, uniform treatment is in order. We would require uniform reports of condition and public disclosures by both banks and thrifts. We would not object, however, to a provision exempting unitary S&L holding companies from the affiliation rules if the S&L is almost exclusively engaged in the origination of residential mortgage loans.

Mr. Chairman, inherent in this entire exercise is the question of where to properly draw the line between "banking" or "financial services" and "commerce." In deciding where to draw the banking/commerce line, Congress should avoid the temptation to grandfather existing relationships. If, for example, it is decided that retailers or manufacturers should not in the future provide depository services, then we see no reason for institutions currently engaged in such activities to be permanently grandfathered. If a combination is undesirable from the public policy viewpoint, it is undesirable regardless of when it was commenced. Once the line is drawn, those whose activities do not conform should be required to divest in a timely and reasonable manner.

Mr. Chairman, let me now turn to certain issues that are not addressed in S. 1609.

Deregulation has increased head-to-head competition between banks and thrifts. It has also increased the ability of depository institutions to gather funds from nonlocal sources so that local markets are no longer insulated from regional and national market competition. At the same time, money funds and diversified financial service companies have become more important competitors for banks and thrifts. Because of these occurrences, standards previously used to evaluate the competitive impact of mergers -- I have in mind the concept of commercial banking as a line of commerce and narrow geographic market definitions, sometimes as small as a single county -- are rapidly losing meaning. There is much less reason for the banking agencies or the Justice Department to be concerned about the merger of two small banks. At present, antitrust standards discourage or prevent such mergers even though the result might be a stronger institution, better able to serve customers and withstand the pressure of changing, more competitive financial markets.

On the other hand, we will need to look more closely at the implications of mergers between large banks and large financial service institutions. If bank holding companies move into life insurance or other fields (or vice versa) largely through de novo entry or through the acquisition of small firms, competition will be increased. However, mergers among large institutions can adversely affect competition. While banks do not currently compete directly with insurance companies when it comes to providing insurance products, major banks and insurance companies do compete in various lending areas. The same can be said for investment banking firms which play a major role in financing real estate projects, municipal and corporate debt and corporate equity issues.

Mergers among large organizations would not only lessen potential competition, they could also lessen competition that exists today. This has not been of overriding concern in the past because legal barriers have prevented the combination of banks, insurance companies and investment banking firms and the merger of banks across state lines. If Congress should decide to remove these barriers, in our judgment the current antitrust law would be inadequate to prevent excessive concentration in the financial services industry.

A second vital issue not addressed by S. 1609 concerns the deposit insurance system. There are various ways we can handle a failing institution, ranging from a payoff of depositors to a variety of ownership transfers that essentially maintain the status quo in the public perception. We are well aware that the deposit payoff is frequently the most expensive and disruptive option so, other considerations being equal, we have traditionally attempted to effect a merger or purchase and assumption transaction. While we believe this is appropriate, it has had the unfortunate side effect of eroding market discipline by providing de facto 100 percent insurance of all accounts regardless of size. We believe this has also created a perception that works to the disadvantage of smaller institutions, whose customers are less sanguine about the prospects for a merger as opposed to a deposit payoff.

We believe our recommendation for a 25 percent coinsurance risk for large depositors, on balances exceeding the insurance limit of $100,000, would have a major corrective influence in this regard. At the same time, steps should be taken to limit the rapidly growing practice of money brokers placing large deposits in banks and thrifts in fully insured segments of $100,000.

We have also recommended a risk-related insurance premium in our study submitted to you last spring. While we do not believe it is costly enough to create a significant deterrent to "go-go" bank or thrift managers, it would be a step in the right direction to recognize banks and thrifts that pursue sound management practices. We would hope that with experience it could be made more effective.

Another issue of concern relates to the payment of interest on demand deposits. Through action taken by the Depository Institutions Deregulation Committee, the process of time and savings deposit deregulation is well along. But it is not clear the DIDC has authority to permit the payment of interest on demand deposits Chairman St Germain has introduced legislation in the House which would accomplish this task. We support this initiative as part of a comprehensive reform measure. Certainly there would be transitional costs to depository institutions; however, the benefits to consumers -- particularly small businesses -- and the flexibility it would provide banks and thrifts clearly makes this a worthwhile proposition.

Enhanced competition also necessitates a change in our views toward the holding of non-interest-earning reserves against deposit balances. As deregulation continues and as banks and thrifts compete more and more with firms not subject to reserve requirements, this is becoming a pressing issue of competitive equality. How can we justify the imposition of 12 percent reserve requirements on transaction accounts at depository institutions when their direct competitors can offer an almost identical product without this considerable burden?

We believe this problem should be addressed through either a significant reduction in reserve requirements or the payment of interest by the Fed on reserve balances, or both.

Another issue not addressed by S. 1609 concerns the regulatory structure. The regulatory system is in a state of disarray. Five different regulatory agencies plus the SEC and the Antitrust Division of the Department of Justice are responsible for regulating the affairs of insured depository institutions at the federal level alone. To cite but two examples, Citicorp is currently regulated by the Federal Reserve, its lead bank by the Comptroller of the Currency, and its California savings and loan by the Federal Home Loan Bank Board. It proposes to acquire a bank in South Dakota (presumably to engage in the insurance business, among other things), and an insured industrial bank in Utah, both of which apparently will be regulated by the FDIC. In addition, numerous state agencies, the Justice Department and the SEC play various roles. The Butcher organization also illustrates the problems inherent in the current regulatory scheme. In that case, some 40 affiliated banks, savings and loan associations and an industrial bank were regulated by seven different state and federal agencies, making accurate identification and assessment of the problems extraordinarily difficult.

In our study on deposit insurance we recommended the merger of the FSLIC and FDIC insurance funds and the reorganization of regulation along functional lines. We continue to believe these reforms are necessary and desirable and feel strongly that Congress should address them in conjunction with S. 1609.

Another matter of concern is the failure of the bill to address the problem posed by recent legislation in South Dakota. Section 14 of the bill preempts the states' rights to prohibit any affiliation between a national banking association and a company engaged in any of the activities authorized by Sections 10, 11 and 12 of the bill. In our judgment, this section should be amended to also prohibit any state from authorizing insured banks within its borders to engage in activities outside its borders that are not permitted within the state.

Finally, the Committee may wish to examine the interstate banking issue. While, as I have stated previously, the FDIC remains neutral on this question, we recognize that de facto interstate banking already exists in large measure and it is only a matter of time before it becomes de jure. I have long felt that an appropriate way to deal with this issue initially would be to allow the states to enter into reciprocal arrangements, possibly on a regional basis. A number of states are moving in this direction but their efforts are clouded by legal questions which the Congress might be able to resolve through enabling legislation.

My conclusion, Mr. Chairman, is not new to you or this Committee. The financial services industry is undergoing a major transition. The worst possible thing Congress could do is to interfere with that transition by enacting some kind of moratorium. In our judgment, a moratorium would only serve to perpetuate the current inequities, reward those who have exploited the weaknesses of the existing statutory framework and further delay attempts to come to grips with urgently needed reforms. We understand the difficulty of addressing the issues we have discussed today, but order must be brought by hard resolutions that will keep all financial institutions in a position to serve the needs of the public, businesses of all sizes and our government units, local and national. We commend your efforts to do this and urge others to join you in what must be a bipartisan effort if it is to succeed.

Thank you again for this opportunity to appear. I will be pleased to respond to any questions you or members of the Committee may have.

FDIC IS OPPOSED TO BANK HOLDING COMPANIES

The CHAIRMAN. As you just stated, you oppose the moratorium as a very limited and stop gap measure. Wouldn't you also agree that if we had a moratorium, it would simply take the pressure off Congress and delay any action on real reform and change?

Mr. ISAAC. Yes, I do agree with that. That's one of my principal concerns about a moratorium.

The CHAIRMAN. I had a long discussion with the Chairman of the Fed yesterday. No matter how hard I tried to convince him that in the 9 years I have been here I have never seen a moratorium used for anything but delay, I didn't convince him. So I just wish it were different. If someone could guarantee me that we had a 6-month moratorium that there would absolutely be no extension of it, and during that period of time, we would be prepared to come up with legislation to replace the moratorium, then I would not oppose one. But I have never seen that happen, where we could place those kinds of restrictions and see that it was used for a contemplative study rather than simply for delay.

You have also testified that there is no need for the S. 1609 requirement of holding companies because brokerage activities in real estate, securities, and insurance are virtually riskless, could be done in the banks themselves and securities underwriting could be done in bank subsidiaries without the cost of holding company arrangements.

Do you feel that the holding company mechanism is unnecessarily cumbersome and expensive, particularly for small banks, in order that they could take advantage of these new services if they were granted?

Mr. ISAAC. The holding company vehicle, in our judgment, doesn't really add anything in the way of protection. You can accomplish all of the objectives that Treasury is attempting to accomplish by requiring separate bank subsidiaries, with capitalization rules and separate funding requirements, and restrictions on intercompany dealings and use of common names and logos and the like. We believe you can build in as many protections into the system with respect to a bank subsidiary as you can with respect to a holding company subsidiary. The reasons why we are opposed to requiring a holding company subsidiary are that it is unduly expensive, and cumbersome, particularly for smaller banks and mutual organizations, to be forced into this structure.

Second, no matter how you organize it, the bank is going to have some risk. There is some risk to the bank. If that's the case, we would just as soon have the bank benefit directly from the profits that are made in the business. If you have this subsidiary organized under the bank, the profits can flow from the subsidiary up to the bank directly. The capital of the subsidiary will be available, in the event the bank gets into trouble, to protect bank depositors, whereas, if it's in a separate holding company subsidiary. It's not directly available—it's only available if the holding company chooses to make it available.

We are an insurer of banks. Banks are facing shrinking profit margins, due to deregulation. In order to improve their profit margins and to provide better service to the American public, we want to see them offer a wider range of financial services. We think that they ought to be able to do that directly. I don't have anything against holding companies, I just don't think we ought to encourage their formation through artificial techniques such as this.

The CHAIRMAN. Well, as you well know, let me carry it one step further. In the original S. 1720, I proposed that banks be allowed to write municipal revenue bonds and engage in money market mutual funds without either a bank holding company subsidiary or a subsidiary. And the argument was constantly made, and particularly with Treasury, which I finally compromised—ultimately that section was taken out totally, and did not become law—but, in any event, the argument was made that it did make them safer, and it protected the parent company.

Now, I agree with what you just said, that you can write in all the protections in a bank subsidiary that you can in a holding company subsidiary. But I carry it one step further. I still have not been convinced that any of these mechanisms insulate the parent organization. Certainly didn't with REIT's. That ought to be a perfect example that that did not solve the problem, did not insulate the parent organization. Why do we need a separate subsidiary if we are going to grant these new powers? Why can't the bank just do it? What do we gain?

Mr. ISAAC. When it comes to money market mutual funds, and revenue bond underwriting, these types of activities, I would agree with you. And with respect to brokerage activities, generally, I would agree with you. I don't see any particular benefit in having them out of the bank.

If we are talking about some of the higher risk activities, some protection is afforded by a separate subsidiary. Also it is easier to impose separate funding requirements and a more uniform regulatory scheme if we put these activities in a separate subsidiary. I just see no need to force people to go through the expense and the hassle of organizing a bank holding company. We are talking about shuffling paper, not reality, when we talk about that.

BANKS AND S&L'S NEED REFORM OF THEIR REGULATORY SYSTEMS

The CHAIRMAN. Well, I agree with you on that point. The Treasury bill serves to increase the Federal Reserve's regulatory domain over both bank holding companies and savings and loan holding companies by adopting the Fed's definition of a bank. These industries have been saying beforehand, though, that they wanted less regulatory power vested in the Fed. What is your feeling, more or less regulatory power in the Fed? I know what you are going to say, I just want it on the record. [Laughter.]

Mr. ISAAC. I believe that we need to reform our regulatory system. I don't believe it comes down to an issue of whether we ought to have more or less power in the Fed. Our regulatory system is in desperate need of reorganization. As I mentioned in my testimony, we have seven Federal agencies involved in these institutions, and it's getting increasingly difficult to effectively supervise them. We have advocated a reorganization of the agencies through the creation of a Federal banking commission and the merger of the insurance funds. Our plan involves removing the Fed from bank supervision. Our purpose is not to strip authority or power from the Fed, it's to fashion a sensible system for regulating banks in this country.

The CHAIRMAN. When I first introduced your bill in the Senate, I stated at that time, quoting you, that you did not want it to be passed, indicating that you wanted Congress to pass more comprehensive legislation instead. What specifically would you like us to pass in addition to what you propose in your bill, to make it more comprehensive?

Mr. ISAAC. There are three principal issues. One is to broaden the powers of financial services organizations, and define what a bank is, and who may affiliate with one; the second major issue is to reform the regulatory system; and the third major issue would be to reform the deposit insurance system along the lines we have suggested.

In addition, there are some collateral issues, such as the payment of interest on reserves, the payment of interest on corporate checking accounts, and perhaps authorizing States to enter into reciprocal interstate banking arrangements, which probably should be tacked onto the bill. But there are three fundamental issues: Powers, regulatory reform, and insurance reforms.

The CHAIRMAN. Comptroller Conover says, referring to interest on checking, that we shouldn't do this without further product line expansion. You regulate thousands and thousands of small banks in the country, many of whom object to paying interest on checking, because they feel it would increase their costs. What effects do you think it would have on small banks you regulate to pay interest on checking?

Mr. ISAAC. In the short run it would have a negative effect on their earnings. In the longer run, it's going to be necessary to maintain their competitive position within the financial services marketplace. The short run earnings problems can be corrected by the banks making adjustments: charging for services that they are presently giving away and reducing costs are two. Many banks have adopted a number of nonprice forms of competition because of the price controls that have been placed on deposits in the past. They have built an excessive number of branches in some cases. and have hired more people than they need in other cases. There's cost cutting that can be done. If we broaden the powers of the banks to offer other services, they can earn some noninterest income to make up for the costs associated with interest rate deregulation. In the long run if the bankers react and we give them the authority to engage in a broader range of activities, we believe that payment of interest on corporate checking accounts will be beneficial.

The CHAIRMAN. Well, beyond that, you feel, whether they like it or not, it's competitively necessary?

Mr. ISAAC. If it's not done, they will simply continue to lose market share. We learned that from our experience with the money market funds and deregulation generally.

The CHAIRMAN. Senator Proxmire.

DANGER OF TRYING TO PASS CONTROVERSIAL LEGISLATION THIS YEAR

Senator PROXMIRE. Thank you, Mr. Chairman. Mr. Isaac, you and Chairman Garn want the full loaf or nothing. I am ready to settle for half a loaf, a slice, in fact, I will even take a few crumbs. It seems to me in this case what you are proposing is likely to take a long, long, long time. The moratorium bill is kind of an easy target, because it says moratorium. Everybody says don't hesitate, do the job, do it now, and all of us like that idea.

But it does close the nonbank loophole. It closes the opportunity for States such as South Dakota to act as they did in permitting a bank to get into insurance outside of that State, and it regulates one—S&L holding companies, so it does accomplish that.

Now what you are suggesting is that we take the Treasury bill, which is already comprehensive, and add all sorts of things to it. On page 6, you say if we are going to remove legal barriers that have prevented the combination of banks, insurance companies, and so forth, then we ought to take a look at the antitrust laws. Then, in addition, you go on on page 7, and say, "We believe our recommendation for a 25 percent coinsurance risk for large depositors would, on balances exceeding the insurance limit of $100,000, have a major corrective influence. In this regard, steps should be taken to limit the rapidly growing practice of money brokers placing large deposits in banks and thrifts. We have also recommended a risk-related insurance premium in our study." Then you have a third proposal, relating to the payment of interest on demand deposits. Then you have a fourth proposal, "a change in our views toward the holding of noninterest-earning reserves against deposit balances." Then you have a further proposal, "We recommend a merger of the FSLIC and FDIC insurance funds and the regulations along functional lines." Then you have another proposal on, "may wish to examine the interstate banking issue." You say, "I have long felt that an appropriate way to deal with this issue initially would be to allow the States to enter into reciprocal arrangements," and so forth.

Isn't this expecting a great deal? After all, next year is a Presidential election year and congressional election year. Everybody argues that controversial legislation is likely to be very difficult to act on, under those circumstances. Why shouldn't we simply deal with the most pressing issues first, I don't see why this would relieve pressure in these other areas, which you properly cite.

Mr. ISAAC. Would a larger package be difficult to pass? Yes; I think it would be very difficult to adopt the larger measure. I am hopeful it can be done. I have been told that we can never have major banking legislation in an election year, but in 1978, which was an election year, we had FIRA. In 1980, we had the Monetary Control Act, which you are very familiar with, and in 1982, we had the Garn-St Germain Act So the last 3 election years we have passed major banking legislation and I don't see why we can't work for legislation in 1984, in early 1984.

I don't see anything going on with respect to nonbank banks that is particularly troublesome. I think we need to redefine the rules and create greater competitive equity among institutions. But there's nothing going on with respect to nonbank banks right now that poses any serious threat to our financial system.

Senator PROXMIRE. What is out there is likely to be used to create a situation which we have to confront and then we might have to undo damage if we find at that time that the system changed too much.

Mr. ISAAC. What I am saying is there's no financial emergency in our judgment. There's nothing that American Express, Shearson, Prudential, Dreyfus and the others are doing in the nonbank area that creates any sort of a financial crisis out there.

Senator PROXMIRE. This is the time to act, once they begin to move in that direction.

Mr. ISAAC. It is the time to act and we should move as quickly as possible. We would simply say the moratorium is not acting. A moratorium is postponing decisions to another day and preserving existing inequities.

Senator PROXMIRE. I hope you and the chairman are right. I will do everything I can to help the chairman get the Treasury bill through, and I hope we can do it. But I fear, and I would predict that we won't be able to get it done this next year. Meanwhile we are going to run into a lot of difficulty, because we will be confronted with a fait accompli and then we will just have to accept the situation.

Mr. **Isaac**. I might just add, a number of our recommendations for reform are items that I know you personally have favored for years. It is my hope that working together, we will get a number of these items enacted within the next 6 to 9 months.

Senator **Proxmire**. I am somewhat puzzled that you didn't mention the FDIC bill S. 1682, in your testimony. In your letter of July 25 to the committee, you indicated that if comprehensive legislation cannot be passed by next summer, that your bill, S. 1682, should be passed. Do you still hold that position?

Mr. **Isaac**. Yes. I think it would be terribly unfortunate if the FDIC bill were passed, because that would mean we failed in trying to achieve our larger objectives. But if we come down to next summer, and there is no other resolution, I think we ought to go ahead and pass that bill, and shut down the nonbank bank activities and require divestiture of those who have entered into nonconforming activities.

Senator **Proxmire**. Let me ask you to do this then. Can you briefly describe S. 1682 and tell us what are the minimum elements of a comprehensive bill that, in your judgment, would preclude the need for passing S. 1682?

Mr. **Isaac**. Well, the three essential elements that I would hope would be in a bill are broadened powers——

Senator **Proxmire**. Are what?

Mr. **Isaac**. Broadened powers, No. 1, reform of the regulatory system, No. 2, and reform of the insurance system, No. 3. I wouldn't be in favor of any package that didn't include all three.

Senator **Proxmire**. If you couldn't get all three, you would be in favor of the S. 1682?

Mr. **Isaac**. Yes.

RESTRICTIONS ON MERGERS, EXPANSION, AND CREDIT LIFE INSURANCE

Senator **Proxmire**. Mr. Isaac, on page 10 of your testimony you suggest that the committee may wish to examine, restrictions on interstate banking. On page 6 of your testimony, however, you raise concerns about mergers among the large financial organizations that would be produced by deregulation of the banking industry and State, and I quote, that "If Congress should decide to remove these barriers, product or geographic, in our judgment, the current antitrust laws would be inadequate to prevent excessive concentration of the financial services industry."

Chairman Volcker made similar concerns, raised similar concerns yesterday, and agreed that it wouldn't be unreasonable to deal with this problem by methods such as, No. 1, forbidding institutions with over 5 percent of our Nation's deposits from expanding by merger—he didn't say he favored that, but indicated some interest, and—2, forbidding any institution with over 20 percent of the deposits in any State from expanding its share within that State by merger. They would be able to expand by de novo branching. What do you think of those suggestions?

Mr. **Isaac**. Those are worthwhile suggestions. One thing we would need is an exception for an emergency situation. But we support some kind of rule along those lines. There are other possibilities; for example, you could provide that any institution that is in the top 25 or so in the country could not acquire an institution that had $500 million or more in assets, except in an emergency situation. There are any number of ways you could formulate a requirement that would be comparatively simple and easy to administer to accomplish the objectives of allowing large organizations to expand on a toehold or de novo basis but not to make major acquisitions.

Senator **Proxmire**. Last year in Garn-St Germain Congress placed specific limits on the abilities of bank holding companies to expand into the insurance area. I take it both you and Mr. Conover, who will follow you, are now recommending that Congress reverse its position and allow bank holding companies to engage in all forms of insurance without restriction. When Congress made its decision last year, it was concerned about the potential anticompetitive effect of combining insurance and banking under one roof and specifically the ability of a bank to use its control over credit to induce customers to buy insurance from its affiliate. Do you have any recent studies or evidence to indicate that those congressional concerns are no longer valid?

Mr. **Isaac**. That is a loaded question because it assumes that I agree the concerns were valid in the first place.

Senator **Proxmire**. And any recent studies that show you were wrong before.

Mr. **Isaac**. I don't think we have had an opportunity to see whether they are right or wrong because banks have never been permitted to engage in the activities. It's speculation that those concerns are real—that there would be illegal tying that could not be controlled through specific prohibitions rather than a blanket exclusion of the banks from this business.

We have seen very little evidence of tying in the one area that banks are permitted to engage in, and that is credit life insurance. There's very little evidence that there's any tying there. When we've found it, we've dealt with it.

Senator **Proxmire**. Are you kidding? Very little evidence?

Mr. **Isaac**. Sure.

Senator **Proxmire**. Holy Moses, I run into that all the time. My time is up. I didn't mean to impose. I am surprised. Let me provide you with some of the evidence that we have.

Mr. **Isaac**. I am not saying you can't find examples of tying in the credit life area—we have. But we have dealt with it effectively. There are laws against it, and if those laws need to be strengthened and if the surveillance and enforcement should be strengthened, then we should do so. I don't see why we should deny the American public the opportunity to shop at a bank or other financial institution for the full range of financial services. Let's say I am a consumer with $20,000. It seems to me I ought to be able to go to my bank or S&L or my brokerage house and ask it to put $5,000 in a savings account, buy an insurance annuity with part of it and invest the balance in stock.

Senator **Proxmire**. You couldn't have picked a worse example than credit life: in some of these cases lenders have a 95 percent penetration ratio.

Mr. **Isaac**. Credit life——

Senator **Proxmire**. The guy making the loan gets the premium on the insurance.

Mr. **Isaac**. Credit life happens to be an attractive proposition to many people. When we see penetration rates around 95 percent, though, we investigate very carefully to see if there's any coercion.

Senator **Proxmire**. Well, my time is up but I think it's an especially attractive proposition to the banker who's selling insurance.

The **Chairman**. Senator Trible.

RISK, BANK RESERVES, AND THE DANGER OF MONEY BROKERS

Senator **Trible**. Thank you, Mr. Chairman. Mr. Isaac, you mentioned some expanded powers are not risky, and therefore could be conducted safely within the bank, whereas others are riskier, and should be conducted in a subsidiary. Exactly, what do you mean by risk, how do you define that term, and should risk be the sole criterion governing where activities and new powers should be located?

Mr. **Isaac**. The risk we are concerned about is the risk that if the activity is unsuccessful, that it would cause severe financial injury to the bank. Occasionally, this will happen, no matter how little risk there is—occasionally an individual bank will get in trouble in a given activity. You have to weigh that risk against the benefit that most institutions would be able to obtain from the activity, through increased earnings, and also consider the potential for vastly improved financial services to the American public. So it's a combination of weighing the benefit to the public, the risk to the bank, the reward to the bank—you balance it. And then there's some collateral issues you want to consider, such as the concentration of economic and financial resources in the country.

Our statement has tried to balance all of those factors.

Senator **Trible**. You have indicated, as underscored by your colloquy with Senator Proxmire, a number of suggestions, one of which is the payment of interest on bank reserves and on bank demand deposits. Flush that out for us, for the record. What is the rationale, what would that contribute?

Mr. **Isaac**. Reserves are very expensive to the banking system. It is my recollection that the banking system right now has about $25 billion in sterile reserves at the Federal Reserve. That's costing the banking system, through a hidden tax, approximately $2.8 billion a year. We might have been able to justify that tax at one time, by saying, "Well, banks are afforded special protections, and they have the ability to access the Federal Reserve and all its free services, and we have interest rate controls to limit competition." But we have dismantled most of those protections, and banks are being thrust into the marketplace and being told to compete head to head against Shearson/American Express, Prudential, and Merrill Lynch. Deregulation is almost an accomplished fact, at least on the liability side. And we are also considering the additional step now of saying interest will be allowed to be paid on corporate checking accounts. We believe that in this kind of environment, we can no longer justify imposing a special hidden tax on the banking system and not on its competitors.

The investment banking houses offer, through their cash management accounts, all the services in the deposit area that a bank can offer—checking accounts that pay interest and offer bill paying services. These accounts don't bear reserves. How can you impose a 12 percent noninterest bearing reserve requirement on a bank and tell it to go compete head to head against an investment banking house that doesn't have that burden? Banks had income last year in the range of $15 billion, and we are talking about $3 billion just for reserves. It's a substantial, substantial burden. We can't justify that anymore in this kind of competitive atmosphere. So we either have to impose the same kind of reserves on all competitors of banks, or we are going to have to pay interest on reserves or reduce them or some combination of all of the above.

Senator TRIBLE. Let's move to another area, the recent development of money brokers, able to break up very large deposits into smaller fully insured deposits, and also capable of putting large amounts of new funds into troubled banks. It seems to pose a threat to banking stability. The role of money brokers in the Penn Square incident is a potential example. Are these activities dangerous, and, if so, what should be done?

Mr. ISAAC. There are money brokers who divide money up into $100,000 amounts, so that the funds are fully insured, and place them in banks at random without regard to the credit quality of the bank. Or in some cases, we have brokers that are actually looking for problem banks to put money in, because problem banks are more desperate for the money, and they will pay a higher fee. The brokers are not taking any risk, because they put the money in the fully insured accounts. Those practices are a very serious concern to the FDIC. What could be done about it is a very difficult, complex subject. We have been looking at it for months, and frankly, we are short on good ideas right now. We intend to come out, within the next few weeks, with an advance notice of rulemaking, in which we will ask for comment from the banking industry, and the brokerage industry and others on steps that might be taken, either through regulation or legislation, to deal with this. The problem is, there are a lot of legitimate activities that we don't want to drag into the net, while trying to get at the activities we you are concerned about.

One idea we have right now, and it seems to be, at this stage, the most feasible thing, is to focus on the banks that are rated 3, 4, or 5 on our rating system. Those are the banks that are considered problem or near problem banks.

We, in almost every case, have entered into a memorandum of understanding or a cease and desist action with these banks requiring correction of problems. We have thought about putting a provision in those memoranda of understanding, or the cease and desist orders, stating that the bank will not be permitted to acquire funds from brokers beyond *x* percent of its deposits without specific consent from the FDIC. That's one way to get at the problem by looking at the problem banks and dealing with them, rather than the brokers.

But there are a few other suggestions we have, which will be contained in this advance notice, and we are hoping we will get some other good ideas when we go out with the notice. So at this stage, I don't have any good answers for you, except to say that it's a serious problem and we are looking at it.

Senator TRIBLE. Good. I thank you for that response. Mr. Chairman, I have some additional questions but rather than take the committee's time I will simply submit those.

The CHAIRMAN. Thank you. Senator Hecht.

FDIC HAS AUTHORITY TO STOP UNSAFE STATE BANKING PRACTICES

Senator HECHT. Mr. Isaac, excuse me, you said just a few moments ago, there is no emergency. What happens if nothing is done? Let's go back to that again. We don't impose a moratorium, we don't have the new legislation. Give me your opinion.

Mr. ISAAC. Well, the financial system will continue to innovate, come up with new ways of getting around the restrictions we have. A few years from now, it will be a very different system than it is today, and the Congress won't have had a hand in shaping that system.

I would prefer that you did have a hand in shaping the system, so I think you need to take action.

I don't think there is a crisis right now that requires you to impose a moratorium in the next 30 days, or next 60 days, or next 90 days. At the same time, I believe we have some serious problems that are developing out there.

But all I meant to say is there is no crisis that requires imminent action, particularly action like a moratorium, which would do nothing to solve any problems and would perpetuate the existing inequities in the system.

Senator HECHT. You mention in your testimony—I will just read the last paragraph. "In our judgment, this section should be amended to also prohibit any State from authorizing insured banks within its borders to engage in activities outside its borders that are not permitted within the State." Could this be done by regulation?

Mr. ISAAC. Not that I am aware of.

Senator HECHT. Not that you are aware of. Would that solve a lot of the problems right now, a simple solution?

Mr. ISAAC. That would solve a particular problem, but that problem, as far as I know, only exists with respect to one State. If I am not mistaken, South Dakota is the only State which has enacted a law to permit State banks to engage in activities outside the borders while prohibiting them from engaging in those same activities within the State.

Senator HECHT. But we are hearing fears that other States might do similar things in other ways.

Mr. ISAAC. Other States have enacted laws which liberalize the powers of their State banks. We don't have any problem with that. That's why we have a dual banking system, so that States can decide these kinds of issues and not have all the rules dictated by the Federal Government. But to the extent States are permitting their banks to move into areas that are clearly unsafe and unsound and pose a serious threat to the financial system, the FDIC has the power, by regulation, to stop that. We have another advance notice of proposed rulemaking out right now for comment, which I alluded to in my testimony, asking for comment on these activities and whether they pose any problems in relationship to the safety and soundness of the financial system or present other problems.

If we, upon studying those comments, find that there are some problems developing, which are not obvious to us right now, that need to be dealt with through regulation, we have the authority to deal with it and will.

Senator HECHT. But the marketplace is always taking care of these problems. In the past certain States have liberalized insurance, and a broker will come to you, an insurance man, and say I wouldn't buy insurance from this State, which has been said many times in the past, so on and so forth. Can't the marketplace handle it? Here's what's happened. It has taken us 50 years to build up confidence in our banking system. An incident happened in my own family, my wife's granduncle died a few years ago, a Spanish American war veteran. He left money in a safety deposit box, because he was burned in the Depression and never put money in the bank.

After 50 years we are just now getting over that because of the FDIC. I see this legislation more threatening than to do nothing. Allowing banks to engage—I'll go on. You said you don't understand why a man can't walk into a bank, have $20,000 and will say, here, put 5 here, put 5 here, put 5 here, how can that be practical?

Mr. ISAAC. Well, it is practical, it can be done.

Senator HECHT. How?

Mr. ISAAC. If we would allow it.

Senator HECHT. How? We have got 14,500 banks in America today, roughly, commercial banks. Who's going to make these decisions? How can this be a practical matter? Whom are they going to walk into in a bank?

DUE TO DEREGULATION, BANKS NEED TO ENGAGE IN FINANCIAL SERVICES

Mr. ISAAC. Well, not all banks are going to be able to offer all services to all people, but some banks clearly will. Other banks will specialize.

Senator HECHT. But if you are going to open the floodgates, they certainly have the right to.

Mr. ISAAC. Right now you can go into major banks and place orders for stock, because discount brokerage is being permitted, or you could place money in a deposit account. I don't know why you shouldn't also be able to order an insurance annuity. In fact, if you don't do anything to prevent it, I suspect that will happen. Not necessarily directly by the bank, but through partnerships arranged between banks and insurance companies.

All we are talking about is allowing the banking system to bring a greater variety of financial services to the American public at more competitive prices. I don't see anything threatening about that.

Senator HECHT. Let's stop right there. How about more competitive prices? Banks have what they call overhead. You mention insurance—insurance man who spent a lifetime, maybe his son is in the business, they are specialists in the business. How can a bank do better than they can?

Mr. ISAAC. If they can't, then I suspect we shouldn't worry about it. We should authorize them to do it and nobody will do business with them because they can't deliver the product at competitive prices. I suspect they can deliver the product at competitive prices, and that they will be successful.

But if they can't, then I don't think this legislation ought to be controversial at all.

Senator HECHT. In banks we have that human element. A man wants to make a loan, and suggests that down the next aisle is an insurance man. So you do have a human element there that you don't have in other industry.

Mr. ISAAC. I am not sure I understood you. You are talking about tying.

Senator HECHT. Yes.

Mr. ISAAC. Tying is a potential problem. We need to deal with that. You have got American Express/Shearson, Prudential, Sears, and others that are engaged in the full range of financial services, and I haven't heard any allegations that they are being coercive and engaging in illegal tying. I don't know why they should be permitted to engage in these activities, and nobody raises any allegations of tying, but yet if we allow banks in the business we immediately worry about tying.

Senator HECHT. No; it's a completely different spectrum because a man who invests in Shearson, Merrill Lynch, is a sophisticated man. Maybe this takes 2½ or 5 percent of the population—that a man, a young couple just getting married doesn't walk in there and say I want a house loan.

Mr. ISAAC. I submit to you that Sears, for example, is trying to attract an entirely different customer base. They are trying to get middle America and blue collar America. And they are likely to be very successful at it, and we will wake up 1 day and find out we don't have any money in insured banks, because it's all outside the regulated system.

Senator HECHT. Maybe they will be successful, maybe they won't. I have been in retailing. Sears a few years ago was a disaster. They are going into it, but that doesn't mean it will be successful. Won't the marketplace work out?

Mr. ISAAC. I wouldn't have any problem if Sears wound up with all the business because they successfully competed in the marketplace and won. But right now, we have got the banks with at least one, if not both hands, tied behind their backs, and you are asking them to go compete against firms that aren't regulated, that are not subject to these restrictions. That's not the marketplace, that's the Federal Government on the one side interfering with the marketplace and on the other side letting them go at it.

Senator HECHT. But Sears has been selling insurance for years and Allstate hasn't put the other people out of business. But let's look at the earnings of the banks the last few years. Have they been that bad that now we have to reinvent the wheel?

Mr. ISAAC. Margins are already shrinking, it's evident that deregulation is shrinking margins. We have to allow the banks opportunities to engage in financial services so that they can replace some of this lost income.

Senator HECHT. My time is up, sir. Thank you.

Senator **Heinz** [presiding]. Senator Hecht.

Senator Sasser.

Senator **Sasser**. Mr. Chairman, I am here as an observer today, all of my questions have already been asked. So I am going to relinquish my time and listen.

The **Chairman** [presiding]. Senator Gorton.

Senator **Gorton**. Thank you, Mr. Chairman.

SPECIAL ANTITRUST LAW NEEDED TO STOP MERGERS AND EXCESSIVE POWER

Mr. Isaac, you do have one, at least, serious cautionary statement to make to us, in connection with what is obviously a broad ranging proposal for deregulation. On page 6, you deal with the potential problem of concentration, and the restriction of competition by reason of potential mergers, should a bill like the Treasury bill or the proposals which you make, pass. We have one sentence there, "If Congress should decide to remove these barriers, in our judgment the current antitrust law will be inadequate to prevent excessive concentration in the financial services industry."

That is certainly a statement with which I agree. First, I should like to ask you what specific kind of changes in antitrust laws should be implemented at the same time as any deregulation such as that reflected in this bill.

Mr. **Isaac**. Senator Proxmire and I earlier were talking about Chairman Volcker's suggestion yesterday that you might have a system whereby any banking organization or other financial organization—we have a problem with definition there—with more than 5 percent of the Nation's financial assets or deposits, however you wanted to phrase it, could not acquire any institution. It would be required to expand either *de novo* or perhaps through a toehold acquisition, except in an emergency. That's a possibility. Also, if an organization had more than 20 percent of the deposits in a State, or some other number, it would not be permitted to acquire within that State, except through a *de novo* or toehold type acquisition. That's a possibility.

Senator **Gorton**. Five percent of all of the assets in the United States is pretty large already, isn't it?

Mr. **Isaac**. That's a big number. And maybe it should be a little bit lower, but we have people approaching that number right now. I would point out that the top 100 banking organizations today have approximately 45 percent of the Nation's banking assets, domestic banking assets. If you include the international assets, it's 53 percent. So roughly half the Nation's banking assets are in the top 100 organizations right now. I have heard some people say, "well, who cares. We get along just fine with only three beer companies, why do we need more banks?" I don't feel that way. I feel that the financial services area is more important. I, frankly, don't care whether I have only got three choices of beer, but I would sure like to know I have more than three choices of places to obtain credit.

Senator **Gorton**. I am delighted to hear you say that, because this member certainly cares.

Mr. Isaac, I guess I can summarize what you said is that we need some special form of antitrust law, in connection with financial services, if we are going to go in this direction, rather than simply relying on the general antitrust laws presently on the books?

Mr. ISAAC. Yes; I would add just one quick note. In the past this hasn't been terribly important because we have had McFadden and Douglas, regulation Q, the Glass-Steagall Act, prohibitions against banks engaging in the insurance business, and the like. These laws have separated all these various industries and drawn boundaries around them, but all of that is coming unglued.

So, we think in a deregulated environment that the antitrust law is going to become much more important in the future than it has in the past.

Senator GORTON. Unless we try to glue it back together.

Mr. ISAAC. I don't think you can glue it back together. I think the only choice we have is to go forward.

Senator GORTON. Let me follow up on that question, because I think it has something considerably to do with what the chairman and this committee have to do about it. Assuming that a thoroughgoing review, and some significant changes in antitrust laws relating to financial institutions, should be a part and parcel of a proposal, such as this one, I also assume that if you don't have sufficient trust in us to figure we could pass the deregulation first and deal with the antitrust issues later, how would you propose that we go about doing that, that among other things, falls within the jurisdiction of a different committee. Should we wait until we can deal appropriately with those antitrust laws before we should actually report a bill on the subject?

Mr. ISAAC. That is more of a political judgment than a matter for a bank regulator to deal with. I don't know for sure whether the committee would feel that it could put provisions along the lines that Chairman Volcker was suggesting in a bill without having it go to the Judiciary Committee. I would say, if you are going to get the antitrust law changed, my political instincts would tell me that the best shot at getting it done properly is in connection with a bill that expands powers.

Senator GORTON. I, certainly, agree with you in that observation. On a closely related subject, tie-in sales, with which I must say I believe I have more trouble than you have, I would tend to agree with some of the concerns which Senator Proxmire and others have expressed, but the bill before us gives trade associations standing to seek injunctive relief against such tie-ins. Do you think that's sufficient?

Mr. ISAAC. It helps. But it's not sufficient. We are still going to need——

Senator GORTON. What?

Mr. ISAAC. We are still going to need of regulatory oversight and proper enforcement. I don't think the private sector is going to do it all. It will do some, and it will be helpful, but I think we still will need to have the Government agencies involved in overseeing this area.

Senator GORTON. Is the threat of the widespread misuse of tie-in arrangements and requirements sufficiently great so that we should not proceed with something which permits that to happen until we are quite certain that we have established sanctions or methods of enforcement to prevent their illegal use?

Mr. ISAAC. Let me say something else. I think this whole tying concern is overstated to a large degree. People can't tie if we have a properly competitive marketplace. The real threat of tying is when you have got a small town somewhere with one bank in it, and there is nobody else around that can give you what you need. If we move forward with deregulation, tying is going to be a less serious problem, because there will be more alternatives available to people. If they don't like the way bank X treats them, they can go to bank Y, or if they don't like X or Y they can go to American Express/Shearson, or somebody else and get the same service without the tie-in. So, I think in a deregulated environment you are going to find tying a less serious problem, assuming we change the antitrust law so that we don't find ourselves 10 years from now with a situation where we have a handful of firms controlling all the action.

Senator GORTON. Thank you, Mr. Chairman. I return my time to you, Senator Garn.

The CHAIRMAN. Before I turn to Senator Heinz, I need to explore this beer issue. It is my understanding you would only like one beer company, Olympia, correct?

Senator GORTON. Unfortunately, we're "Pabst" the ability to do that.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman. Iron City is actually the best.

Senator GORTON. Never heard of that one.

Senator HEINZ. That's the problem.

Mr. ISAAC. Maybe we could talk about ketchup companies. [Laughter.]

Senator HEINZ. Far too much competition.

DEREGULATION OF FINANCIAL SERVICES WILL IMPROVE BANK PROFITABILITY

Mr. Isaac, one of the central themes that you and some bankers have struck, regarding why we should deregulate the banks of financial services, is that first, it's good for the consumer to allow one stop shopping, and, second, the banks need it, their profit margins are shrinking. They are all about to hang up going-out-of-business signs. Starting with the latter first, do you have any evidence at all that it is financial services competition that is depressing profit margins as opposed to, for example, bad loans or the need to compete for funds through offering a higher interest rate on money market deposit accounts and the variety of needs they now have at their disposal to quite successfully compete? It would seem to me that competition usually leads to lower profit margins, and I would suggest, perhaps, that your analysis that their profit margins are lower is, in fact, either evidence that they are competing or that they have some other problems. I have never heard of competition improving profit margins.

Mr. ISAAC. I would agree. One reason profits are down is that loan losses are up due to the economy. But the interest margins themselves are shrinking. That is primarily due to deregulation and the high and volatile rate climate we are in.

Senator **Heinz**. Then I think you and I agree on that, don't we?

Mr. **Isaac**. The cause doesn't matter. The fact is, profits are shrinking and we have to do something about it. We have to give banks an opportunity to earn some money from somewhere else.

Senator **Heinz**. Only if you assume that that will do two things. One, that it will truly improve their profit margins, and I don't know of any evidence, one way or the other, that supports that point of view. It may, it may not.

Second, one would be inclined to give banks additional powers to earn more money, or less inclined to do so, depending on the degree of risk associated with that, inasmuch as there is a general presumption even in the Treasury bill, the most avid deregulators, that somehow we want to preserve safety and soundness of the banking system. We don't want to undermine it. I don't know of anybody who wants to undermine safety and soundness of the banking system, and it is not immediately clear what the tradeoff between safety and soundness and these earnings opportunities is. We don't need to debate that. That is the tough political judgment that the committee has to make. But the judgment that we touched upon a moment ago, which is that banks need this in order to earn more money is an interesting one. And what evidence do you have that this will really allow them to make more money, those poor hard pressed bankers.

Mr. **Isaac**. Well, I would say first that insurance agents and companies generally seem to make money. Merrill Lynch makes money. I have no reason to believe that a banker couldn't enter those businesses and make money.

My second response would be similar to the one I gave to Senator Hecht. That is, if banks can't earn money doing this, then what is the harm in passing legislation? They are not going to offer these services and not make money. So all you have done at worst is authorize somebody to do something they aren't going to want to do.

Senator **Heinz**. Well, we tried that, I think, with real estate investment trusts.

Mr. **Isaac**. What?

Senator **Heinz**. Banks were allowed to invest in real estate trusts, set up REIT's, as I recall them being called.

Mr. **Isaac**. Right.

Senator **Heinz**. I think people argued back then, well listen, if these things don't work out, the banks won't do them anymore, and there will be no problem. Banks don't do them anymore.

Mr. **Isaac**. They don't do them anymore.

Senator **Heinz**. They don't do them anymore. Of course, the No. 1 bank in Pennsylvania is not exactly what it used to be because they did go into real estate investment trusts.

Mr. **Isaac**. Not because of that problem.

Senator **Heinz**. It was one of their big problems.

Mr. **Isaac**. It was a factor, but it was a minor factor.

Senator **Heinz**. One bullet will rarely kill a large beast. It takes two or three. In this case, three bullets arrived, and there was a little rigor mortis setting in until the FDIC rode to the rescue.

What you are suggesting is sending in Kemper along with them. I couldn't resist that.

The **Chairman**. Let the record show he called the biggest bank in Pennsylvania a beast.

Senator **Heinz**. Let me reflect on a very good question. I think we would be guilty of being somewhat cavalier if we simply said, gee. They don't do it, no harm can ever come of it, because it may take them awhile to find out that they lose money. If they find out in some substantial way that going into the insurance business isn't all it's cracked up to be, you, at the FDIC, will be stepping forward to cover up the mistake in a perfectly legal sense.

Let me, therefore, suggest, that it would be helpful to the committee, if you really do have some evidence, and to any witnesses, that indeed this is somehow going to improve banks profitability. Let me ask a second question. We are talking about financial services deregulation, securities, insurance, banks offering cash management accounts, which is bill paying, why wouldn't the next logical step—Merrill Lynch offers cash management accounts. Banks can't quite offer that, but they do offer bill paying services—why isn't the next step to go from bill paying to helping their customer order for what it is they are paying?

Mr. **Isaac**. I think that is a very logical next step.

Senator **Heinz**. That's called being a mail order house.

Mr. **Isaac**. Or an agent.

Senator **Heinz**. By the way, to the extent risk is involved, it's about as riskless as being a securities broker or insurance broker. It would seem very logical to me as I gather it would to you. Do we want the banks to become Sears Roebuck or L. L. Bean?

Mr. **Isaac**. I couldn't agree more that banks ought to be permitted to offer the full range of brokerage or agency type services where they act in the middle. That's far less controversial, in our judgment, and far less risky than considering things like real estate development and the like.

WHERE IS THE SEPARATION BETWEEN BANKING AND GENERAL COMMERCE

Senator **Heinz**. I understand that. I am just asking the question, if the step is they should be able to offer any of these services that deal with intangibles, pieces of paper, promises to pay, which is what money is in our system. We don't have dollar bills. It's all promises to pay. Why isn't the next most logical step, and a very short one, for them to get into dealing in hard goods, brokeraging hard goods. That's what L. L. Bean does.

Mr. **Isaac**. You mean a broker of timber or——

Senator **Heinz**. Well, whatever. Come into your bank and order all your housewares.

Mr. **Isaac**. Oh, that kind, OK.

Senator **Heinz**. Yes. They already give the housewares away. Why not make some money on it?

Mr. **Isaac**. I would have to think about that a bit. I thought you were referring to engaging in commodities as a broker.

Senator **Heinz**. No. I am sure that would happen too, but, no, I am talking about going the next step. If you have got a customer, really, all we are talking about, is if you are a bank, how do you become like Sears?

Mr. ISAAC. I was going to say, we already have a bank like that—Sears.

Senator HEINZ. Sears has the customer coming in to buy lawnmowers and they want to do some other business with them. If a bank is going to want to eventually sell, not today, not tomorrow, but eventually they are going to want to be able to sell lawnmowers, if there's a buck to be made out of it. Is that good?

Mr. ISAAC. That goes beyond where we are proposing to go right now.

Senator HEINZ. I understand that.

Mr. ISAAC. It raises a very difficult question. Throughout our history, we have had a very strong conviction in this country that there ought to be a separation between banking and general commerce—that the banking firms ought not to be involved in the oil business or the lawnmower business for a variety of reasons.

One is the issue of concentration of economic political power and what that might mean. Other countries, such as Germany and Japan, have not had those barriers, at least to the degree we have had. Their banking systems work, they are healthy. And——

Senator HEINZ. The reason I ask the question, I have to interrupt you, because I got a little note from my Chairman saying my time has expired.

Mr. ISAAC. Sure.

Senator HEINZ. Probably not an answerable question by you or any specific person here, and particularly here today, is that to—I think it might help all of us to try and deal with that question, even though in a sense it's academic, because no one is proposing it, to understand exactly where the lines and what criteria we ought to use for drawing lines on how far, if we decide to go forward with legislation, we will of some kind, where to draw, exactly to draw a line while we are drawing it. You said all we have to do is make up our mind and pass legislation.

Mr. ISAAC. Right.

Senator HEINZ. We probably have, how many members do we have, Mr. Chairman, on this committee, right now.

The CHAIRMAN. We have 18 members.

Senator HEINZ. We probably could produce 18 different bills that would be different at this point. One request I would have for you. You recently proposed regulations that allow State chartered banks to engage in the securities business. That affects some 9,000 State chartered banks, and your argument for doing so is that you are really compelled to do so by the reading of the law that your General Counsel gives you. We are responsible for making the law that your General Counsel reads. Will you please submit to us the memos of your General Counsel's office dealing with this subject over the last few years so we can see your interpretation?

Mr. ISAAC. I will if we can. I believe we have been requested by somebody on the House side for those memos and we have declined on grounds of privilege, but I will see what our legal situation is on releasing those memos. If we can, we will.

Senator HEINZ. I thought we helped pay the salary of the General Counsel.

Mr. ISAAC. There are rules relating to release of the opinions, and I will look at it and see what the legal situation is. If I might just say a word on the other points you made.

Senator HEINZ. Appreciate it.

Mr. ISAAC. About having to draw the line and commerce, and having to go through that exercise—I think we do have to go through that exercise and see why it is we are drawing any lines. We have done that at the FDIC. A few weeks ago we sat around several hours debating why we should have a line between banking and commerce at all? What are the origins of it? Why do we care? I think that is a useful exercise to go through. I don't think your question is purely a hypothetical question. I know that's not an issue before us right now, but it helps you understand why it is you are putting a line there at all, and it helps you decide just where you want it.

Senator HEINZ. And I apologize to my colleague, it's a little less than hypothetical in this sense. When you have Sears Roebuck coming at banks, it is not illogical to think that banks are going to want to go as far as Sears Roebuck, and the net result of deregulation here is not just to let banks do things they can't now do, it also will be a continued encouragement for every other kind of strong organization, whether its Sears Roebuck, General Motors, IBM, to go toward financial services, if they think they can make a profit out of it. So, in one sense, it's academic, in that no one's proposing it, and in another sense it's very real because there are forces out there that will force us to reconfront this question.

Mr. ISAAC. Plus its possible that some of those firms you have mentioned as a result of the legislation will be required to divest. If you are going to require divestiture, you have to have a rationale.

Senator HEINZ. Mr. Chairman, I apologize to you and my colleagues for going over time.

The CHAIRMAN. No problem. Are there any other questions before we turn to the next witness? We do have additional questions for your response in writing. We thank you for being here today.

Mr. ISAAC. Thank you very much.

[Response to written questions of the committee follows:]

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429
Office of Congressional Relations and Public Information

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Years of Confidence
1933 – 1983

October 7, 1983

Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

This responds to your letter of September 19, 1983 wherein you submitted additional questions to supplement Chairman Isaac's testimony before your Committee on September 14 with respect to S. 1532, S. 1609, and S. 1682.

Attached are the responses to these additional questions.

Please let us know if we can be of further assistance.

Sincerely yours,

Graham T. Northup

Graham T. Northup
Director

Attachment

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

1. In our oversight hearings last June, we heard some scholars disagree with the idea of risk-related deposit insurance, an idea which you proposed in your statement. Professor Paul M. Horvitz said:

> "If the insurance agency has the power to close (an) institution if its true net worth declines to zero, there are vitually no risks to the insurance system. The Franklin National Bank was our largest bank failure. It failed with no loss to the insurance system because it was closed when its net worth got to zero..."

In short the risk to the deposit insurer is not that of a bank failing, but that of a bank being allowed to operate with negative net worth. This argues against risk-related insurance and in favor of diligence against a specific hazard - operation below zero net worth - which is not related to the size of a bank's failure or even the riskiness of the specific bank's lending policies. How would you answer this assertion?

Answer: There are several problems with this assertion. First, the chartering authority closes a bank, the insurer does not and cannot close banks. Second, having a bank closed at the precise instant of insolvency and confirming losses to an amount equalling capital funds occurs very rarely in real-life situations. If we possessed the predictive powers and omnipresence necessary to control all bank losses with such precision, we would opt to curtail them well in advance of depletion of the bank's capital. The fact is that banks do fail, despite our efforts. We obviously prefer that the penetration of creditors' claims be minimal at the time insolvency is discovered, and sometimes it is. But for the very reason we are unable to stop bank failures from occurring, we are unable to absolutely limit the extent of insolvencies.

Third, after a bank has failed, we liquidate the assets. There is little doubt that such a liquidation process occasions greater losses than would the operation of a going concern.

We agree that preventing losses is the superior methodology, and that providing for their absorption is a distant second preference. But since the former is, in our judgment, unattainable, we must rely on the latter. That being the case, the least we can be expected to do is to exact the greatest premiums from those posing the greatest risk to the fund.

2. You would give banks very broad powers yet are neutral on interstate banking.

a. Isn't this inconsistent?

b. Would you allow the broadened powers to be exercised across state lines?

c. Then what is the difference?

Answer: As you know, we already have nationwide competition for most financial services. The wholesale banking market has long been a national one. On the retail lending side, we have national firms, some of which are bank affiliates, making consumer and real estate loans on virtually a nationwide basis. The only major remaining geographic restriction relates to the taking of deposits. Moreover, even without interstate branching, retail deposit markets have become less insulated from out-of-state competition in recent years. Money market funds and the recent increase in brokered deposits have shown us that retail money can be attracted through the mail when rates offered are high enough, and the deregulation of the deposit rate ceilings has increased the ability of depository institutions to penetrate deposit markets without a physical presence. All this suggests that geographic restrictions are becoming less important than in the past.

Historically, geographic restraints have served as a proxy for antitrust enforcement; that is, by limiting the areas in which banks were permitted to expand, the restraints fostered a larger number of competitors. As the restraints are dismantled, there is a tendency toward greater concentration of financial resources in fewer hands. We believe significant additional concentration should be avoided.

That is why our stance on interstate branching is one of neutrality. Current antitrust laws don't appear adequate to deal with potential concentration in the financial services industry, particularly if the geographic barriers to interstate branching should be precipitously dismantled. Under present law we are required to focus entirely on narrow geographic and product markets; overall concentration and the structural effects of combinations are not adequately considered. Too often this results in disapproval of a merger between two small banks in the same community while, at the same time, permitting the nation's largest financial conglomerates to make one major acquisition after another. We believe this situation should be corrected.

In order to obtain further data on possible approaches to this problem, the FDIC recently requested public comment on various types of expanded powers for banks. One of a series of questions posed as part of this proposed rulemaking was whether existing antitrust laws are adequate safeguards against excessive concentrations of economic power that may result from bank participation in new product markets and, if not, whether it would be appropriate to limit bank entry into new activities to de novo entry. We will be happy, as we have already indicated, to share with you the results of this request for public comment when available.

3. You support interest on checking. Comptroller Conover says don't do this without further product line expansion.

You regulate thousands of small banks, many of whom object to paying interest in checking because it would increase their costs.

What effects would this have on small banks' earnings and capital?

Answer: It is clear that the initial impact on small bank earnings from the payment of interest on demand deposits would be negative. DIDC staff analysis indicates that initial annual transition costs to small banks (those with assets of less than $100 million) would be somewhere in the $213 to $433 million range. This represents 4.5 to 9.0 percent of 1982 pre-tax profits for these banks. (A more detailed examination of these costs is included in the DIDC Staff Memorandum titled "The Payment of Interest on Demand Deposits" which was attached to the August 4, 1983 letter sent to your Committee which recommended a removal of the prohibition of the payment of interest on demand deposits.)

One should be mindful, however, that these costs are of a transitory nature. Currently the payment of interest on demand deposits is accomplished indirectly through the provision of free services or through devices such as otherwise unnecessary bank branches. With the allowance of direct payment of interest on demand deposits we would expect to see these indirect mechanisms disappear. This will cut bank noninterest expenses and help to defray additional interest costs. Within several years we would expect to see small bank profitability return to what might be considered a "normal" level.

Overall, we think these transitional costs are well worth the benefits which could be gained. The prohibition on the payment of interest on demand deposits leads to inefficiences since, as a result, some bank services are not properly priced.

Additionally, inequities are created. Large corporations -- through shrewd cash management techniques -- have been able to skirt the prohibition by investing excess demand balances in short-term investment vehicles such as certificates of deposit, federal funds and repurchase agreements. The practical result is that interest is earned on demand deposits. Smaller businesses generally lack both the knowledge and the quantity of funds necessary to accomplish this. Therefore, an inequity between small and large businesses exists.

Moreover, we might add that the increased involvement of nondepository institutions in the banking business will continue to develop at a rapid pace. You are all well aware that securities firms provide attractive alternatives to the checking account through so-called "Cash Management" or "Asset Management" accounts. Not only do they offer virtually all of the features -- such as direct payroll deposit and telephone bill paying services -- that bank checking accounts offer, it is also likely that they will offer some form of "deposit" insurance.

We are involved in a critical transition period where financial institutions of all types are positioning themselves for the marketplace of tomorrow. We strongly believe that all institutions should enter this competition with equal footing.

The effect of a $213 to $433 million reduction in earnings upon capital would be mitigated by an unexpected reduction in both income taxes and dividend payments. Assuming an effective tax rate for these banks of 45 percent and a dividend-to-net-income ratio of 30 percent, the impact on bank capital can be estimated to be a negative $82 to $167 million. This represents approximately two to five-tenths of one percent of the equity of small banks (currently at $35 billion). We should also note that small banks generally have stronger equity positions than do their larger counterparts. The average equity-to-asset ratio for banks with assets of less than $100 million is 8.75 percent while that of banks with $100 or more in assets is 5.39 percent. Thus, while the payment of interest on demand deposits may be relatively more expensive for smaller banks, they would be in a better position to absorb any potential negative earnings.

4. In your statement you argue that banks now have too many regulators, including the Antitrust Division at Justice. Yet you also point out that "large" bank mergers are not addressed by S. 1609. Would you retain the jurisdiction of the Antitrust Division over bank mergers, and if so, over what sizes of bank mergers?

Answer: As indicated in our response to Question 2 above, we have requested public comment on how present antitrust laws might have to be revised in light of the expansion of bank powers. We have taken the position in the past that under a general revision of the bank regulatory structure it might make a lot of sense for the Justice Department to assume sole responsibility for enforcing the antitrust laws with respect to financial institutions. If this suggestion were adopted, we would work with the Department of Justice to develop a position on how the statutes should be revised and what size bank mergers should be subject to the Department's review. We do believe, however, that any such revision of the antitrust laws should deal with the types of issues alluded to in our response to Question 2 and in my September 14 testimony before your Committee.

5. You favor payment of interest on bank reserves and on bank demand deposits. Why?

Answer: Consideration of the payment of interest on bank reserves must be viewed within the context of the current deregulatory trend plus the enhanced competition that we have seen from nondepository institutions. Both of these factors have served to reduce bank profit margins and, as a result, make the correction of regulatory inequities more important.

With an elaborate system of interest rate controls and other protective mechanisms, it would be possible to argue that reserve requirements are the "price" of this special protection. But the protective mechanisms are being dismantled, and banks are being thrust into the harsh realities of the marketplace. Under the circumstances banks must be afforded the ability to vie with competitors on an equal basis.

As we mentioned in our answer to Question 3, the involvement of nondepository institutions in the banking business will continue to develop at a rapid pace. Securities firms now offer demand deposit-type accounts without the burden of any kind of federally imposed reserve requirements. This creates a competitive imbalance which cannot be tolerated.

The substantial cost of required reserves has to be borne by both banks and their customers. If the $25 billion of reserve balances were available for investment in today's market, they would generate about $2.8 billion in additional income. That is a lot when one considers that net income of commercial banks on domestic and foreign operations amounted to about $15 billion last year.

Reserve Requirements also lead to an unnecessary proliferation of bank accounts. For example, with substantial transaction reserve requirements, it pays a customer to hold separate NOW and savings accounts. Without reserve requirements it is likely that many customers would combine the two accounts which would lower costs and add convenience.

Our response to why we favor interest payments on demand deposits is contained within our answer to Question 3.

6. The recent development of "money brokers", able to break up very large deposits into smaller, fully insured deposits, and capable of bringing large amounts of new funds to troubled banks, seem to pose a threat to banking stability. The role of money brokers in the Penn-Square incident might be an example. Do you agree that these activities are dangerous? If so, what should be done about them?

Answer: As you know, we are deeply concerned about the misuse of brokered deposits as well as other large denomination liabilities, including deposits of certain governmental units, which are completely protected by deposit insurance.

One of the traditional "fail safe" mechanisms limiting the damage caused by unscrupulous or incompetent bankers is they literally "run out of money" with which to perpetrate their misdeeds. This, of course, is less true in banks that the public perceives to be too large for the FDIC to pay off. But, with the use of insured brokered deposits, that safeguard system is overridden even in the smaller banks, greatly enhancing their capacity for creating losses for creditors and the Federal deposit insurance fund to absorb. Moreover, on a number of occasions the availability of these funding sources has retarded regulatory efforts to deal with problem or failing institutions.

Unfortunately, while we know the problem, the solution is not so obvious. The FDIC will soon issue an Advance Notice of Proposed Rulemaking in the Federal Register to solicit comments on the nature of deposit-brokering activities and the manner(s) in which to deal with such practices. The FDIC will evaluate the comments received from the public in conjunction with various approaches currently under consideration. These approaches follow two general avenues, intensified monitoring and supervision of broker activity or reduced insurance coverage for brokered deposits. The techniques under most active consideration are discussed below.

Registration and Reporting by Deposit Brokers

Legislation could be enacted requiring that firms doing a brokerage or referral business in insured deposits register with the FDIC and be subject to FDIC reporting requirements. This approach would not curtail deposit brokering but it would enhance our ability to track the activity and respond to individual cases of misuse of large denomination liabilities. While some might view this measure as unwarranted encroachment by the Government into the private sector, we cannot be sympathetic to this because Federal insurance is the main reason for the proliferation of deposit brokers. The ability to monitor the suppliers (and users) of brokered funds would not resolve the greater long-term problem -- i.e., the loss of market discipline by creditors -- but it should help us deal more effectively with the immediate problem.

Increased Monitoring of Insured Institutions

Starting with the September 1983 Call Report, all FDIC insured institutions will be required to report quarterly on the volume of brokered deposits. However, these data may not be available quickly enough to provide for prompt regulatory action. One solution would be to impose special reporting requirements whenever brokered funds become significant. Banks could be required to report, for example, when large denomination liabilities exceed 20 percent of total liabilities and thereafter when significant changes occur in the level or cost of brokered deposits. Banks with lower CAMEL ratings (3, 4 or 5) could be subjected to more intense requirements; the trigger level for reporting could be set at a lower percentage or approval might be required prior to any broker involvement. The FDIC has in fact commenced inserting this sort of restriction in certain administrative actions.

This approach would not require legislation and would help focus regulatory efforts upon those institutions with the greatest potential for abuse. The disadvantage is an increased reporting burden for banks using large denomination liabilities for prudent purposes. Moreover, as with broker registration, increased reporting will not have an impact on market discipline, an important FDIC goal.

Modification of Insurance Coverage

Legislation designed to roll back insurance coverage on broker arranged deposits would help restore market discipline. These deposits could be made noninsured or brokers could be treated as principals with total insurance limited to $100,000 regardless of the individual rights of ownership. Efforts along these lines would pose some definitional problems but classifying all deposits arranged through third parties for a fee would capture the bulk of the activity. However, the issues involved in reducing insurance coverage are complex, and we are still evaluating the feasibility of such options.

In conclusion, a number of actions may be appropriate to resolve the broker issue. Probably the most effective approach would be to roll back insurance coverage, but it also has the most potential for disrupting the current banking system. Legislation requiring registration and reporting by brokers and special reporting by banks may represent the most practical steps at this time.

7. You mentioned that some bank powers (such as real estate, securities, and insurance brokerage) are not risky, and can be conducted safely within the bank. Others are riskier, and should be conducted in a subsidiary with separate capitalization and funding.

a. Exactly what do you mean by "risk" in these statements? Why isn't brokerage risky, but underwriting is?

b. Are you suggesting in your testimony that "risk" be the sole criterion governing where activities and new powers should be located?

Answer: "Risk," as used in our statement concerning enhancement of banking powers, refers to the risk of loss of capital. We believe brokerage activities, by their purely service-oriented nature, pose very little risk to the capital accounts. On the other hand, taking a financial position in securities being underwritten, insurance being underwritten, or real estate being developed carries with it a considerably greater risk in our opinion.

In our testimony, we gave prominent treatment to risk because control of risk to capital funds is paramount to FDIC. We suggested that subsidiaries be created for the conduct of certain new activities to limit risk to bank creditors. In our judgment, this corporate protection is a prudent and necessary measure in view of the overriding importance of protecting depositors. Obviously, the entity conducting the new activities should be truly separate and capable of standing alone to give the bank's depositors maximum legal protection from insolvency of the nonbanking entity. Just as is the case with any stockholder, the owner of the entity would have the option of undertaking rescue. We would assume that regulatory capital standards would be a factor to be considered in any such action.

We believe the legal protection and the inclination toward voluntary rescue are practically the same in a bank subsidiary and a holding company subsidiary. It is our opinion, therefore, that banks should have the option of these two arrangements. We find the bank subsidary clearly superior to the holding company subsidiary for the reasons outlined in our testimony. Since we would require investment in subsidiaries to be excluded from bank capital before applying regulatory measures of adequacy, the failure of a subsidiary, per se, would not render capital inadequate. Yet, if the bank were to fail, the investment in subsidiary would be available to help satisfy depositors' claims. This would not be the case if the subsidiary were owned by a holding company, unless the holding company's board of directors made the decision to contribute the subsidiary to the bank's creditors.

The **Chairman**. Next I would like to invite the witness, the Honorable C. Todd Conover, Comptroller of the Currency, who has been standing in back with the witnesses and refused to take a seat, to come forward.

STATEMENT OF C. TODD CONOVER, COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY

Mr. **Conover**. It's quite comfortable back there.

The Chairman. Mr. Conover, please go ahead.

Mr. **Conover**. Mr. Chairman, I have a longer statement that I would like to enter into the record, then I have some brief opening remarks, then I would be happy to answer any questions you and your colleagues might have.

Mr. Chairman, members of the committee, it is a pleasure to present my views on S. 1609, the Financial Institutions Deregulation Act (FIDA) and on other major issues involving the deregulation of the financial services industry. These views are not necessarily those of the administration. I have testified on numerous occasions about the need for change in the laws governing depository institutions. Today I would like to focus on why further deregulation is necessary and how I believe such deregulation should occur.

WHY DEREGULATE FURTHER?

The job of deregulating depository institutions is only partially accomplished. In fact, this partially deregulated environment is placing severe pressure on banks. If further steps are not taken, the consumer of financial services will be the loser, and our depository system will become weaker.

Interest rate deregulation puts pressure on margins

Until recently, depository institutions were forbidden by law to compete for consumer deposits based on interest rates. Thus, they invested heavily in brick and mortar facilities and competed on the basis of convenience and service. The high operating costs associated with this approach were offset by the low interest expenses fostered by regulation Q. Since interest margins were high, most banks and thrifts had little incentive to be cost efficient. some accounts and services were probably unprofitable, but most institutions did not have the cost accounting systems in place to identify them.

The lifting of interest rate ceilings has changed the picture dramatically. Banks and thrifts can no longer afford to offer costly services and convenience without charging higher prices. Earnings gained from paying low rates of interest are no longer available to offset losses that result from serving low-balance accounts and maintaining a costly delivery system with a limited product line.

Banks have limited strategies available

In making the transition to price-based competition, banks must reevaluate and possibly revamp their entire mode of delivering financial services. They have essentially three strategies open to them. First, in the short term they can raise fees and try to reduce operating costs. Second, they can streamline the delivery system by closing branches and increasing the use of electronic facilities. Third, they can sell more products through the existing delivery system in order to spread fixed overhead costs.

Ideally, institutions would choose a blend of these strategies. Of the three possible strategies, repricing existing services is being pursued most aggressively. It provides shortrun benefits and is the most free from regulatory constraint.

The second strategy, streamlining the delivery system, is appealing as a somewhat longer term response. However, State and Federal laws often limit the ability of banks to operate ATM's or to join together to achieve economics of scale.

Unfortunately, the third strategy, to expand product offerings, is also severely limited by persent law. Yet it is this strategy that is most likely to assure the availability of financial services to the greatest number of consumers.

Consumers and small businesses will benefit

The public is not well served when banks and thrifts are forced to close branches and increase fees. However, unless banks are permitted to pursue other strategies, they may have no other alternative. Pressure to cut services will be reduced, however, if institutions are allowed maximum flexibility in adjusting to a market rate environment.

I am not predicting that some bank customers will be unable to obtain financial services in the future. They will be able to do so—but not necessarily from banks. Many may turn to such organizations as Sears, Kroger, J. C. Penney, or finance companies. Unless changes are made, depository institutions will continue to find themselves vulnerable to competition from organizations with a competitive advantage—one that arises not from superior management skill but from legislated inequities.

CHOICES OPEN TO CONGRESS

There are essentially three choices open to the Congress. It can: Take no action, impose a temporary moratorium, or address the problem and rewrite the legal framework within which financial institutions may operate. I definitely support the third option.

To do nothing would mean customers would continue to be denied access to competitive, efficiently delivered financial services. Imposing a moratorium in order to study the problem would take pressure off Congress but would generate no new information. Now is the time to rewrite the laws governing the financial services industry. It is clearly the best option.

FIDA WILL PROVIDE NEEDED FLEXIBILITY

S. 1609 will improve our financial system by permitting insured depository institutions to be more responsive to the needs of the marketplace. Moreover, the health of the industry will be enhanced by enabling institutions to diversify their narrow product lines.

The requirement that new activities be carried out in a holding company affiliate, coupled with stringent restrictions on interaffiliate transactions, should be adequate to prevent conflicts of interest. Undue concentrations of financial power will continue to be precluded by the Bank Merger Act and our antitrust statutes. In addition, the proposed restrictions on interaffiliate transactions will preclude the holding company from unfairly using lower cost Government-insured deposits to fund growth in its other activities.

Finally, FIDA would create a system of functional regulation that is fundamentally equitable. Institutions engaged in like activities would be subjected to the same regulation, regardless of who owns the institution.

Suggested improvements to FIDA

However, FIDA falls short of meeting an important test—imposing as few restrictions as possible. I would propose improvements in two areas for consideration by the Congress.

Under FIDA's provisions, banks would be empowered to add mutual fund and municipal revenue bond underwriting to their present securities powers. In addition, securities firms that do not engage in corporate underwriting could also acquire full-service banks.

However, the underlying structure of the Glass-Steagall Act would remain unaltered. Further, FIDA creates new restrictions by expanding the definition of a bank to include institutions that have or are eligible for FDIC insurance. This effectively prevents full-service securities firms from owning any type of bank. I support, and the public would benefit from, empowering such firms to engage in retail banking.

This result could be accomplished by adopting a less restrictive definition of a bank—that is, an institution that "accepts insured deposits and makes commercial loans." If that definition were incorporated into both Glass-Steagall and the Bank Holding Company Act, securities firms and other types of companies could own consumer-oriented banks.

The other way in which S. 1609 falls short of my criteria is that it is silent on much needed geographic deregulation. This deregulation will be extremely important as institutions attempt to lower overhead costs and to expand volume to achieve efficiency. To this end, I favor removing geographic barriers to competition. As an interim step, I support regional experimentation with geographic deregulation, such as is contained in S. 1002. I also favor changing the definition of branches to exclude unmanned electronic facilities. These changes would provide banks with needed flexibility.

ADDITIONAL ACTION AND CONCLUSION

There are other matters before the Congress not contained in FIDA on which I would like to comment. First, I support the payment of interest on demand deposits, but only in conjunction with significant product deregulation.

Second, I favor the payment of interest on reserves. This tax hampers the ability of depository institutions to compete.

Third, I support reoganization of the financial regulatory structure to achieve efficiency and equity.

In conclusion, let me reiterate that further deregulation is definitely needed. It is the public that has already benefited from deregulation and will continue to benefit in the future. It is time we got on with the job.

Thank you, Mr. Chairman. I would be happy to answer any questions.

[The complete statement follows:]

STATEMENT OF
C. T. CONOVER
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
September 14, 1983

Mr. Chairman, members of the Committee, it is a pleasure to present my views on S. 1609, the Financial Institutions Deregulation Act (FIDA), and on other major issues involving the deregulation of the financial services industry. These views are not necessarily those of the Administration. I have testified on numerous occasions about the need for change in the laws governing depository institutions. I would like to reiterate and expand on those views today by focusing on why further deregulation is necessary and how I believe such deregulation should occur.

As I discussed in my April 27, 1983, testimony before this Committee, many studies over the past 15 years have supported deregulation of financial services. Indeed, so many respected people have testified before congressional committees on legislation to accomplish some aspect of financial services deregulation, it would be easy to assume that there is a general consensus in favor of substantial deregulation of depository institutions. Unfortunately, however, that is not the case. If it were, we would have accomplished more deregulation than we have. To date, we have only granted much needed asset flexibility to thrift institutions, and effectively eliminated interest rate ceilings on time deposits.

WHY DEREGULATE FURTHER?

The job of deregulating depository institutions is only partially accomplished. In fact, this partially deregulated environment is placing severe pressure on banks. There are important further steps that need to be taken. If they are not, the consumer of financial services will be the loser, and our depository system will become weaker.

Interest Rate Deregulation Puts Pressure on Margins

Until recently, depository institutions were forbidden by law to compete for consumer deposits based on interest rates. Thus, they had to compete in the only other way they could -- on the basis of convenience and service. They invested heavily in brick-and-mortar facilities within their prescribed market areas, and kept them open for long hours, in order to attract customers.

The high operating costs associated with this approach were offset by the low interest expenses fostered by Regulation Q. In fact, interest margins were high and left institutions substantial room for error. Most banks and thrifts had little incentive to be cost-efficient -- an effort that would have required complex cost accounting systems to identify the actual costs of providing individual products and of serving individual customers. Some low-balance accounts were probably unprofitable, but most institutions did not have the systems in place to identify them.

The lifting of interest rate ceilings has changed the picture dramatically. Banks and thrifts can no longer afford to offer costly services and convenience without charging higher prices. Moreover, competition from non-depository institutions has increased. And many do not have the substantial fixed costs associated with extensive networks of banking offices. As a result, they have marketed their services predominantly on the basis of interest rates paid and have targeted the most profitable customer segment -- those with high balances. Thus, the profits once reaped by depository institutions by paying low rates of interest, particularly to high balance customers, no longer exist. They are no longer available to offset the losses resulting from serving low balance accounts and maintaining a costly delivery system offering a limited product line.

Banks Have Limited Strategies Available

In making the transition to price-based competition, banks must reevaluate and possibly revamp their entire mode of delivering financial services. They have essentially three strategies open to them. First, in the short term they can raise fees and try to reduce operating costs. Second, they can streamline the delivery system by closing branches and increasing the use of electronic facilities. A third response would be to sell more products through the existing delivery systems in order to spread fixed overhead costs.

Ideally, institutions would choose a blend of these strategies. Of the three possible strategies, repricing existing services is being pursued most aggressively. It provides short-run benefits and is the most free from regulatory constraint. However, the true cost of servicing existing accounts under the current structure may be so high that institutions will lose customers if they pursue only a repricing strategy. More importantly, some consumers and small businesses may be unable to obtain affordable banking services from a local, traditional bank.

The second strategy, streamlining the delivery system, is appealing as a somewhat longer-term response. However, there are severe regulatory constraints on the ability of institutions to pursue this strategy. Attempts by banks to join together and achieve economies of scale are often limited by state branching laws or by federal restrictions on interstate branching. An ATM, which is much less expensive to operate than a full-service branch, may not be permitted by state law if it is across the street, or in the next county, or in the next state.

Unfortunately, the third strategy, to expand product offerings, is also severely limited by present law. Yet it is this strategy that is most likely to assure the availability of financial services to the greatest number of consumers. The existing delivery systems of banks and thrifts could be used to profitably offer other financial services, such as insurance, real estate services, and expanded securities activities. By allowing more products to flow through the existing network of offices, the cost of delivering existing services would be lowered. This would enable consumers to obtain a broader array of services at affordable prices through their local depository institutions.

Consumers and Small Businesses Will Benefit

I do not believe that the public is well served when banks and thrifts are forced to close branches and increase fees. However, unless banks are permitted to pursue other strategies, they may have no other alternative. Pressure to cut services will be reduced, however, if institutions are allowed maximum flexibility in adjusting to a market interest rate environment.

I am not predicting that some bank customers will not be able to obtain financial services in the future. They will be able to do so -- but not necessarily from banks. Many may turn to such organizations as Sears, Kroger Supermarkets, J. C. Penney, or finance companies. Unless changes are made, depository institutions will continue to find themselves vulnerable to competition from organizations with a structural competitive advantage -- one that arises not from superior management skill but from arbitrary legislated inequities.

CHOICES OPEN TO CONGRESS

Regulators have taken steps to expand the permissible activities of banks by relaxing overly strict interpretations of old laws, such as allowing depository institutions to engage in discount brokerage services. For the most part, however, we may have gone as far as possible, given current statutory restrictions on bank activities. For further broadening of powers, legislative action is needed.

There are essentially three choices open to the Congress. It can:

1. Take no action;
2. Attempt to halt the more innovative and controversial developments (particularly combinations of depository and nondepository institutions) by imposing a moratorium in order to allow further deliberation on the issues; or
3. Address the problem directly and rewrite the legal framework to address the public policy and marketplace concerns as they exist today.

I definitely support the third option.

Take No Action

To continue to do nothing would only perpetuate inequities. It would also continue to deny customers access to competitive, efficiently delivered financial services.

Impose a Temporary Moratorium

The second alternative, to impose a moratorium, would be even more detrimental to the marketplace. By opting for a moratorium instead of taking no action, the Congress would merely be substituting one set of inequities for another.

Institutions that have already expanded in a manner that would be curtailed during a moratorium would be in a competitively advantageous position.

Moreover, to impose a moratorium simply delays the inevitable. The issues have been studied numerous times over the last two decades. Time after time, similar recommendations have come forth indicating the need to restructure the industry. At this point, more study will yield little more than another report and another citation.

Undertake Fundamental Reform

Now is the time to rewrite the laws governing the financial services industry. The marketplace is moving ahead rapidly in the creation of new financial services. Unfortunately, regulated depository institutions are being forced to design complex financial services to fit legal loopholes discovered by lawyers, rather than simply responding to market demands. Now is the time to enact legislation that will ease the transition for both depository institutions and their customers.

In considering the appropriate legal structure to govern the financial services marketplace, three fundamental goals of federal regulation should be kept in mind. First and foremost, the stability of the depository system must be preserved. Second, federal regulation should prevent abuses arising from conflicts of interest. Third, regulation should prevent undue concentrations of financial resources.

To these traditional goals, which I fully support, I would like to add two more: (1) that the federal government intervene in the financial services marketplace only to the extent necessary to serve these traditional goals, and (2) that regulation apply equally to all participants performing the same functions. Excessive regulatory intervention not only results in inefficient delivery of financial services, but also provides incentives for circumvention of the regulations. And it creates a need for further regulations. Attempting to counter natural market forces is an impossible undertaking that imposes costs on both the regulated industry and the consumer.

An integral part of minimal regulation is equitable regulation. For example, banks and thrift institutions, which offer substantially similar products, should be regulated in the same way. Similarly, securities activities of banking companies ought to be regulated in the same way as independent securities firms. To subject competing institutions to different capital standards and other rules is inequitable and undermines one of the purposes of regulation.

FIDA WILL PROVIDE NEEDED FLEXIBILITY

S. 1609 substantially addresses these concerns. It will improve the stability of the financial system by making it possible for insured depository institutions to be more responsive to the needs of the marketplace. Moreover, the health of the industry will be enhanced by enabling institutions to diversify their narrow product lines.

The requirement that new activities be carried out in a holding company affiliate, and at the same time maintaining stringent restrictions on interaffiliate transactions, should be adequate to prevent conflicts of interest. Undue concentrations of financial power will continue to be precluded by the Bank Merger Act and our antitrust statutes. More importantly, the proposed restrictions on interaffiliate transactions will preclude the holding company from unfairly using government-insured deposits to fund growth in its other activities at a cost advantage over competitors that do not own banks.

Finally, FIDA would create a system of functional regulation that is fundamentally equitable. Institutions engaged in like activities would be subjected to the same regulation, regardless of who owns the institution.

Suggested Improvements to FIDA

However, FIDA falls short of meeting an important test -- imposing as few restrictions as possible. I would propose improvements in two areas for consideration by the Congress.

Under, FIDA's provisions, banks would be empowered to add mutual fund and municipal revenue bond underwriting to their present securities powers. Those existing powers include general obligation bond underwriting and retail brokerage activities. In addition, securities firms that do not engage in corporate underwriting could also acquire full-service banks under FIDA.

However, the underlying structure of the Glass-Steagall Act would remain unaltered. Further, FIDA creates new restrictions by expanding the definition of a bank to include institutions that have or are eligible for FDIC insurance. This effectively prevents full-service securities firms from owning any type of bank. I support, and the public would benefit from, empowering such firms to engage in retail banking.

This result could be accomplished by adopting a less restrictive definition of a bank -- i.e., an institution that "accepts insured deposits and makes commercial loans." If that definition were incorporated into both the Glass-Steagall Act and the Bank Holding Company Act, securities firms and other types of companies, could own consumer-oriented banks. Potential conflicts of interest and concentrations of corporate financial power would be precluded. And the consuming public would benefit from increased competition in retail financial services. Essentially all financial services holding companies would then have to choose between engaging in commercial lending or corporate securities underwriting, but would be free to compete for consumer deposits, lending and retail brokerage accounts.

In allowing these retail banking institutions, Congress may want to consider incorporating certain safeguards against a company utilizing a retail bank primarily to support its other business activities. If a nonfinancial enterprise selling consumer goods also makes consumer loans to finance the sale of that product, there is the potential for abuse if the loans are funded with federally insured deposits. The potential for such abuse should be limited.

The other way in which S. 1609 falls short of my criteria is that it is silent on much needed geographic deregulation. This deregulation will be extremely important as institutions attempt to lower overhead costs and to expand volume to achieve efficiency. To this end, I support regional experimentation with geographic deregulation, such as is contained in S. 1002. I also favor changing the definition of branches to exclude unmanned electronic facilities. These changes would provide banks with needed flexibility.

Additional Action

There are other matters before the Congress not contained in FIDA on which I would like to comment. The first is a proposal to allow interest payments on demand deposits. As you know, the Depository Institutions Deregulation Committee has recommended that such interest payments be allowed. I support this action, but only in conjunction with broader deregulation. To allow interest payments on demand deposits without providing substantial product or geographic deregulation would just exacerbate the problems facing the banking industry.

Second, I favor the payment of interest on reserves. The requirement that depository institutions hold non-interest-bearing deposits with the Federal Reserve System amounts to a tax on banks and thrifts. This tax hampers the ability of depository institutions to compete with nondepository financial institutions, and should be removed.

Third, I support reorganization of the financial regulatory structure to achieve efficiency and equity. Moreover, as further deregulatory legislation is enacted, the need for such restructuring becomes even more important.

CONCLUSION

In conclusion, let me reiterate that the objective of further deregulation should be the safe delivery of improved financial services to the American public. It is the public that has already benefitted from deregulation and will greatly benefit from further deregulation. It is time we got on with the job.

The CHAIRMAN. Thank you very much, Mr. Conover. On pages 11 and 12 of your prepared statement, you make a proposal that goes beyond the Treasury bill by allowing companies to engage in corporate securities underwriting and to accept insured deposits. Several people have voiced fears about conflicts of interest such as overselling securities to customers or investing deposits in marginal securities issues. Do you think such conflicts could be prevented in your proposal?

Mr. CONOVER. Yes, I think they can. What I am suggesting here is not that full service securities firms be permitted to engage in both corporate underwriting and commercial lending, but that they be made to choose between one or the other, so presumably the securities firm would stick with corporate underwriting. But I think it ought to be permitted to operate what amounts to a consumer bank and accept deposits and make real estate loans, or operate a credit card business, or make other types of consumer loans. In doing that, I think there are ways to prevent conflicts of interest from occurring.

The CHAIRMAN. On page 12, just at the last of your summarized testimony, you discuss geographic deregulation or changes in McFadden, and you suggest experimentation in this area. I suppose you are talking about the New England experiment as an example, and you favor that legislation?

Mr. CONOVER. That's correct. I think that would be a good interim step toward geographic deregulation.

The CHAIRMAN. Are there other areas around the country expanding that experimentation further? Do you have suggestions for other areas, natural market areas?

Mr. **Conover**. Well, as I understand it, there are discussions going on in the Pacific Northwest, and among various banking industry groups, as to whether they would like to participate in such an experiment. I am pretty sure that discussions have taken place in the Southeast as well. If they would like to do that in either of those two areas, I think that would be a step in the right direction.

The **Chairman**. You also propose taking ATM's out of the definition of a branch. Wouldn't this, in effect, take a great deal out of McFadden?

Mr. **Conover**. Yes, I think it would. But it would also provide an opportunity for banks to take advantage of the new technology that is available to them to operate systems across State lines more efficiently, and I think that the consumer would be well served by such a change.

The **Chairman**. Well, assume we went to either regional type experimentation or eventually to full scale interstate banking. Do you believe there ought to be some restrictions? I think you were in the audience when Chairman Isaac was talking about it, also Chairman Volcker yesterday talked a great deal about preventing concentrations by having limitations of one sort or another.

Do you favor those kinds of limitations?

Mr. **Conover**. Well, I think it's obvious that one of the objectives of Federal regulation ought to be to prevent undue concentrations of economic or financial power. So I would favor some kind of arrangement that would accomplish that. It seems to me that if we do remove geographic barriers, that we do end up with increased competition, and I think that the near term potential for undue concentration is pretty slim. I think that goes to something that Senator Gorton was discussing with Chairman Isaac as to whether or not you would need to include some kind of a restriction in this legislation. I am not sure that that's necessary. I don't think the timing is such that it would be essential that you do that.

TIE-INS AND THE BANK HOLDING COMPANY

The **Chairman**. Insurance groups generally are opposed to the provisions of S. 1609 on insurance provisions. William Baxter, when he testified, said he didn't feel there was any foundation for the worries about tie-ins. What is your feeling? Does S. 1609 adequately address tie-ins, or if insurance provisions are removed, do you need more legislation?

Mr. **Conover**. Tie-ins are a troubling area. I think we have to be careful in this legislation or any other that expands the powers of banks or other depository institutions that we have in place a mechanism to prevent tie-ins.

At the same time, I think we need to be careful because, at least for me, one of the reasons for permitting banks to offer a broader range of services, is to allow them to package and combine certain aspects of services traditionally offered by other institutions into new products and services so that the public will benefit.

Unfortunately, when people ask, "Well, what do you have in mind?" Since I'm not a product designer, I can't give three great ideas off the top of my head. But it seems to me that not every imaginative financial service product has already been invented. In preventing tie-ins, we don't want to put such restrictions on institutions with broader powers that they can't use their marketing, innovative talents to come up with new, interesting, profitable products, or combinations of products that the public would like to have.

The CHAIRMAN. At a recent meeting of the FDIC, they voted to conduct regular examinations of federally chartered savings banks, and discussed the possibility of examining national banks regularly. Do you consider this a proper activity for the FDIC?

Mr. CONOVER. I think if you were to review the minutes of that particular meeting, you would find that I objected to that provision strenuously and voted against it.

The CHAIRMAN. I know you did. I just thought you would like the opportunity to say something.

Mr. CONOVER. I appreciate the opportunity. I think that the primary regulator ought to, and normally does, (at least we do), invite the FDIC to join in an examination of a bank where the bank is in difficulty or in extremis. It is essential for them to do so in order to protect their insurance interests. We have done that in the past, and we will continue to do it in the future. But I don't think that the FDIC should have a blanket right to examine national banks or federally chartered savings and loan associations simply whenever they want to.

The CHAIRMAN. You also mention pricing strategies and other ways in which banks can reduce their costs and increase earnings. What about the bankers' banks that were authorized in Garn-St Germain? Do you think these are beneficial to small banks? Have any of them been created yet?

Mr. CONOVER. I think they are beneficial to small banks, but so far I think the incidence of their establishment has been relatively limited. I can't cite the number of cases or the specifics that have been put together to date, but I would be happy to submit that in writing if you would like.

The CHAIRMAN. Chairman Isaac also talked a good deal about not needing the bank holding company subsidiary. Do you subscribe to that viewpoint, that they are unnecessarily cumbersome and expensive; are they necessary or not necessary?

Mr. CONOVER. Well, I think that's one of the most debatable points relating to the proposed bill: should these things be in the bank, or should they be in the bank holding company? I differ from Chairman Isaac; I think they ought to be in the bank holding company. Let me give you some of the reasons why. In his proposal, he says, "Well, you could have separate capital in the subsidiary, and you could count the bank's capital for capital adequacy purposes, excluding the capital of the subsidiary." That means you essentially end up with the same kind of system as if you had the subsidiary of a holding company. True, the profits would end up being retained in the subsidiary, unless they were paid out to the bank. In terms of looking at bank capital, you can end up with exactly the same position as if you had a bank holding company subsidiary. That is, the profits of the subsidiary could be paid out to the holding company and downstreamed to the bank in order to meet regulatory capital requirements.

I think it would be better for the bank holding company to go into the market for funding based on the strength of all its activities rather than having a subsidiary of the bank have to try to raise money in the capital markets.

I think that the proposal to have these new powers in the bank would permit banks to get into other businesses, but I don't see how it would permit other financial service companies, such as insurance companies, real estate organizations, or securities firms, to acquire or get into the banking business.

I could go on, but it seems to me that on a net basis, I would prefer that these activities be carried out in the holding company. I think it provides some insulation from potential risk. I think it's a more effective way to run an organization from a management point of view as well.

The CHAIRMAN. How did you vote when the FDIC proposed additional activities? I understand there have been a couple of votes the last month or so.

Mr. CONOVER. One—well, I think there were probably two that you are referring to. One was the advance notice of proposed rulemaking that was going out to ask questions of people about how these new activities ought to be regulated. Since it was, in my view, a fact gathering rather than a decisionmaking move, I voted in favor of doing that.

I suppose an earlier issue would be where the FDIC issued regulations governing the securities activities by nonmember banks, and I voted in favor of those, as I recall.

The CHAIRMAN. Senator Hecht.

BANK EXAMINERS AND REGULATION OF LIKE INSTITUTIONS

Senator HECHT. Thank you, Mr. Chairman. On page 9, you have the first point, "The stability of the depository system must be preserved." How can stability be maintained with deregulation? It seems to me a lot of confusion can result from this.

Mr. CONOVER. Well, I think the fundamental point, Senator, is that we have put the banks in a very difficult position at the moment through the deregulatory steps that have already been taken. We have deregulated the liability side, but we haven't done anything for banks on the asset side. I think that the stability of the system can be strengthened if banks are permitted greater flexibility to respond to the marketplace and the changing economic conditions by having some new powers. And rather than weaken the banking system by giving them those powers, I think actually we will strengthen it.

Senator HECHT. OK. Second, "Federal regulation," I don't agree with you, by the way, "should prevent abuses arising from the conflicts of interest." Can you effectively legislate against tie-ins?

Mr. CONOVER. Well, we already have some laws on the books that prevent tie-ins, and I think that, in the process of going through this legislation, it's probably appropriate to review those laws and satisfy ourselves that they are working. As I said earlier, I am concerned about the potential for tie-ins.

Senator HECHT. Do you think, yes or no, you can effectively legislate?

Mr. CONOVER. I think you can establish a law that makes tie-ins illegal, that defines the conditions under which they would be deemed illegal. Then I would think you would get into a question of enforcement actions, which would be carried out, in this case, by bank examiners to see that tie-ins do not take place.

Moreover, as I recall, in the bill itself, there is a right of action that can be taken on the part of trade associations in tie-ins, specifically in tie-in situations, and I would think that would go a long way toward dealing with the problem.

Senator HECHT. Let's talk about bank examiners. They always do something after the fact. How can they prove denial of credit which was the result of a tie-in?

Mr. CONOVER. They probably couldn't after the fact unless there was a complaint by a consumer who said, "I believe that I was denied credit, or that I was granted credit on unfavorable terms or less favorable terms, than would have been granted to me if I had purchased this other product or service." Such a complaint is really no different than other consumer complaints that come to the bank regulatory agencies and get investigated. It's not a perfect system, but that's probably the only way that those anti-tie-in provisions could be enforced. Someone would have to complain.

Senator HECHT. Let's go down to No. 3, still. "Regulation should prevent undue concentrations of financial resources."

What kind of regulations are you talking about?

Mr. CONOVER. Well, here we are getting into areas that were discussed briefly earlier, about whether mergers ought to be permitted between large financial organizations and the like. In our interpretation of the Bank Merger Act, and in rulings where we have been involved in mergers, we have argued for a long time that the markets ought to be defined quite broadly, and that, for example, banking, per se, ought not to be defined as a line of commerce in determining whether undue concentration exists. Rather, in looking at a given marketplace, one ought to consider all the competitors that are offering financial services in that marketplace to determine whether an undue concentration exists. So you would therefore consider thrift institutions operating in the same market. That's the most obvious example. You could also look at money market deposits that were gathered in that market, if the data were available. You could also consider insurance companies in determining concertration. The question of undue concentration would end up being dealt with on a case-by-case basis either by the bank regulatory agencies or by the Justice Department.

Senator HECHT. Well, I want to dwell on that a little more with you. You say down in the next paragraph, "For example, banks and thrift institutions which offer a substantially similar product should be regulated in the same way." Practically, you have got two different types of examiners right now. How would you practically do that?

Mr. CONOVER. Well, this opens up several areas of discussion. First of all, go back and look at the Garn-St Germain Act and the powers that were granted to thrift institutions. If they were to take full advantage of the things they can do on the asset side of their balance sheet, they could create a balance sheet that looks essentially like a commercial bank without having a dollar's worth of mortgage loans in it. What I am saying is that if thrifts use those powers and essentially become, for all practical purposes, commercial banks, then they ought to be regulated in the same way as commercial banks. That means with the same capital requirements and so forth.

The second point that your question brings up has to do with the subject of reorganization or restructuring of the regulatory agencies. As you know, there's an effort going on right now, under the auspices of the Vice President, to look into what the regulatory structure ought to be.

Each of the agencies has submitted a report or proposal, and the staff has been digesting those and trying to come up with what will be a workable solution. We have a number of further discussions among the principals to go through before we are even close to an agreement and ready to submit something to the Congress.

I don't know how that is going to work out. But as a matter of principle, in order to regulate like institutions in the same way, I think the examinations ought to be done by the same examining forces.

Senator **HECHT**. Don't you see chaos on that? Where do you get the regulators all of a sudden?

Mr. **CONOVER**. In what way?

Senator **HECHT**. In other words a bank examiner goes in and looks at banks, you have people going into thrifts looking at them, you have got State people examining them. All of a sudden, how can this all be worked out real fast?

Mr. **CONOVER**. Well, I am not sure it can be worked out real fast, but I think almost everybody agrees that the regulatory structure that is in place is not satisfactory, particularly where you have three different Federal banking agencies involved in bank examination and supervision, and you have an agency that regulates the holding company and still another that is responsible for examining a savings and loan association that might be part of the same holding company. It is a chaotic situation and that is why we are working to see if there's a way to rationalize that.

SMALL BANKS CAN AND WILL COMPETE WITH LARGE BANKS

Senator **HECHT**. Why do you say it's chaotic, hasn't it served our country very well?

Mr. **CONOVER**. It served the country well in a different environment. I think the financial services industry is probably going through greater change today than it has in the last 50 years, certainly going back to the 1930's. I think that the mechanisms that were put into place then served the country well for a long time.

But I think the time has come now where, in my judgment, and in the judgment of many others, this system has ceased to be the most effective way to supervise and ought to be changed.

Senator **HECHT**. One question here. I mentioned earlier that there are 14,500 commercial banks in America today. We have had numerous experts, since I have been in the Senate the last 8 or 9 months, no one has really agreed on anything. Let me ask you this, point blank. Don't you think that if we would come forth with all these different deregulations, that within 10 years we would have 100 banks in America?

Mr. CONOVER. No, I don't.

Senator HECHT. Why not? How could practically—can smaller banks operate under this situation?

Mr. CONOVER. Let me give you two reasons why I don't think the number of banks will shrink so dramatically. First of all, in order to get from 14,500 to 100, we would have to have approximately 1,000 mergers a year for the next 12, 13, 14 years, and 1,000 mergers a year works out to 4 a day. There's no way that we could accommodate four mergers a day simply from an administrative viewpoint. And, I don't think the market place is going to move at anywhere near that kind of pace.

Second, I think if you look at a market like California, where you have some of the largest banks, the largest savings and loans, many finance companies, leasing companies, venture capital firms, and insurance companies operating, I think you would have to agree that that is a highly competitive financial services market. Year in and year out, the best performing banks in that market are the small community banks. I think that they will continue to prosper in a deregulated environment, as they have in the somewhat protected environment in which they have operated in the past. I think they will do so by offering a different brand of service. And I think that they will continue to have close community identity. I think there will be certain categories of customers that will always prefer to deal with a local institution, rather than with the branch of the multinational giant.

In short, I think small banks will do just fine. I think the people who run small banks in other States that have different structures might not agree with that. Frankly, I think that's probably because they don't know how good they are, really, in the competitive world. I do think that running a bank in the future, be it a large one or a small community one, will be a more difficult management job than it ever has been in the past.

Senator HECHT. My time has expired but I do want to repeat what you just said. Under the present system, banks do operate effectively, smaller banks against larger banks. The future is yet to come.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me comment on that. We have had considerable testimony over the years on that. I don't remember whether you were here or not when Walt Wriston testified. But I specifically asked a question—I knew the answer beforehand, I didn't expect it quite as bluntly—but asked him a question about how well Citicorp had fared in upstate New York against the smaller banks. They fared very poorly and they closed offices and they didn't compete with that small localized service. His comment was, it's in the record, "They cut off our heads and put them on a platter and handed them back to us."

Last year, in 1982, in California, with BankAmerica, and other very large institutions, both S&L's and banks, more banks were created in California than in any year in history. There's more diversity—believe me, you deal with the rest of the United States, then you deal with California. Every time you get involved with these issues—doesn't matter whether it's California realtors, California homebuilders, or anything else, you deal with them separately, because, if they don't like what their national association is doing, they threaten to pull out of the national organization, because they have got 25 percent of the dues. California is incredibly diversified with a wide, wide diversity of financial institutions. I just wanted to add to what the Comptroller said. I don't fear there's going to be 100 banks in the country controlling everything. I think it's too competitive. These smaller institutions are going to do rather well in whatever kind of an environment. They are doing surprisingly well against some of these big boys who become bureaucraticized like many of the Federal agencies and stumble all over themselves and don't provide as good a service as they might, certainly not personal service.

Senator HECHT. Mr. Chairman, may I just make one comment.

The CHAIRMAN. Certainly.

Senator HECHT. Just as I said to Mr. Conover, under existing regulations, without changing the laws, they can do this. They can operate effectively.

But when you have to change the whole system, I question it. I just asked a question.

The CHAIRMAN. Well, first of all, you are not going to change the whole system overnight. That will take time. You will have transition periods, and I think they will adjust. The smaller institutions have come through one of the most difficult periods of time in their existence, particularly the thrifts and those involved in long-term lending.

Two years ago, the environment was very, very difficult, and those that were well managed survived rather well. A lot of those that did go out of business had nothing to do with regulatory structure or deregulation or anything of that nature, they were poorly managed institutions. The ones that had taken good care of themselves, and had bright management, do fine, and I think that will continue. You didn't need very much in the way of brains, particularly, to be a successful president or chief executive officer of a savings and loan in the part. The Government told you everything you could possibly do, what percentage of your assets you put in this basket or that. There were no decisions to be made. Each morning when you went to work, you just did your work and you made a profit. You were guaranteed one. Until we got in a difficult financial situation where now, you find the thrifts complaining because they have actually got to manage, they have to make decisions, they have to be competitive. I don't mean to belabor the point. But if we have dramatic changes over the next few years, and have further deregulation, I would expect in this country it would continue to be quite different than the European and other countries that you will have a wide, wide diversity of financial institutions, and, whether it was as Todd said or Bill before, innovations will come along, and there will be products being offered in services that we don't even know about today. I just marvel at what has taken place in the financial services industry in the last 5 years. People that are bright and are capable are going to survive and they are going to beat the socks off of some of these big boys who are bound up, as I say, in that bureaucracy.

Senator Gorton.

Senator **Gorton**. Thank you, Mr. Chairman.

The **Chairman**. That's not out of your time.

BANKS NEED PROTECTION; THEY HAVE A FUNCTION IN OUR ECONOMY

Senator **Gorton**. In your testimony, Mr. Conover, I think you wisely urged that regulation apply equally with all participants forming the same functions. Does that mean that you support the imposition of reserve requirements in cash management accounts and other similar services now being offered by brokerage and other firms?

Mr. **Conover**. No, rather, I would do it the other way. I would pay interest on the reserves gathered from depository institutions. We should not continue a tax on banks that puts them at a disadvantage vis-a-vis their nonbank competition.

Senator **Gorton**. Nevertheless would you require reserves on cash management accounts offered by institutions other than banks?

Mr. **Conover**. The only purpose in requiring reserves on those accounts would be for monetary policy considerations, and I would have to go to the Federal Reserve Board on that issue.

Senator **Gorton**. Yesterday Mr. Volcker suggested that a regulatory distinction might be drawn between thrifts which retain the character of those institutions, as opposed to those which would expand aggressively into broader financial arenas, but he did not suggest specific criteria for making that distinction.

What is your impression of that?

Mr. **Conover**. I think the point is that thrifts have a bunch of new powers under the Garn-St Germain Act. If they start to really take advantage of those powers, and in effect become banks, then I think they ought to be regulated like banks. I am not sure exactly what the test ought to be. It probably ought to have something to do with asset mix.

Senator **Gorton**. So as a general proposition——

Mr. **Conover**. I don't have any problem with that.

Senator **Gorton**. You find the suggestion of Mr. Volcker attractive. Now if Congress should pass the Treasury bill, for your own suggestion, and the present form, much of the attractiveness of what we now call the South Dakota loophole would disappear. But if we pass a restriction of bank powers, that is unlikely to happen, should we, under those circumstances, take some action to plug the South Dakota or the State powers loophole?

Mr. **Conover**. I think the South Dakota loophole, if I understand your question correctly, is the one in which State banks are permitted to conduct activities outside of their home State that they cannot conduct inside their home State. That makes no sense to me.

I think that's totally unfair, and, frankly, I don't think it ought to be permitted. If your are referring more broadly to the subject of the so-called nonbank bank, that is essentially what I have proposed in my testimony. It seems to me that such a bank should exist in its consumer form—that is, that it takes deposits and does not make commercial loans. Now, technically speaking, under today's law, one could have a nonbank bank that does not accept demand deposits, but makes commercial loans. I have problems with that, because I think that's where you end up with the potential for conflict of interest. But I don't see any difficulty in a securities firm—or any other firm, for that matter—engaging in the business of consumer banking, providing, as I indicated in my full, written testimony, that it doesn't simply want to get into that banking business to finance the sale to consumers of some product that it manufactures.

Senator GORTON. Thank you. Mr. Chairman, I have a couple of other questions, but, in the interest of time, I would submit them in writing.

The CHAIRMAN. Just checking to see if Senator Heinz has additional questions he wishes to ask you before we close.

Senator HEINZ. Sounds like you would like some brief questions, Mr. Chairman.

The CHAIRMAN. Well, if you want to eat, it's entirely up to you. However, it's what condition your stomach is in.

Senator HEINZ. It's all right, Mr. Chairman.

The CHAIRMAN. I think I should announce however to the Senator, that Senator Stevens is supplying Alaska seafood for Republican Members of the Senate.

Senator HEINZ. We have a few minutes.

Mr. CONOVER. Senator Heinz, if I may, you ought to check the relative size of the banks in Pennsylvania, and you will note that the Mellon bank is the largest bank in Pennsylvania. That goes back to your earlier discussion with Chairman Isaac.

Senator HEINZ. I should have had Philadelphia.

The CHAIRMAN. The Mellon bank isn't a beast; right?

Mr. CONOVER. It certainly isn't.

Senator HEINZ. Depends on whether you want to borrow money from them or not. Mr. Conover, you suggest that without expanded powers, the importance of banks in our financial system is going to diminish; is that right?

Mr. CONOVER. Yes, I do. I think they will end up losing market shares to nonbank institutions.

Senator HEINZ. Now, last year we supplied in the Garn-St Germain bill a number of competitive instruments that were to enable banks to be directly competitive. Those instruments were super-NOWs and MMDAs. Let's assume, for the moment, what you predict does not happen, OK.

Mr. CONOVER. OK.

Senator HEINZ. You really have the competitive powers that they need. So, to be kind of a devil's advocate, if the only way to protect the safety and soundness of the banks is to continue to limit their activities, what would be so wrong about our financial system being less dependent on banks?

Mr. CONOVER. Well, the consumer or the small businessman probably doesn't care where he gets many of his financial services. So, from that standpoint, the economy probably wouldn't be harmed at all, regardless of whether many financial services were obtained from banks or from other companies, whatever they happened to be called. But banks occupy an important position in our payment system, particularly since they offer deposit insurance, which I hope we won't extend to other types of organizations. They occupy a unique place in our economy.

Somewhere in there, there's probably a monetary policy consideration.

UPDATE LAWS TO ALLOW FOR INSTITUTIONS FAIR OPERATIONS

Senator HEINZ. I am glad you mentioned the deposit insurance issue. I think we ought to get one thing kind of understood. Money is going out of insured accounts, into other kinds of accounts. That's really what is happening. When Sears Roebuck says, here, let me set up a cash management account, where we will do all kinds of things, or whether the Mellon Bank were to set up a cash management account, what happens is that the money goes from an insured checking or savings account into some other kind of account, is that not right?

Mr. CONOVER. That certainly is true, but the public has shown a preference, since December, for having insured accounts.

Senator HEINZ. I know. But the reason I am trying to make that point is that Chairman Isaac and you suggested that if we didn't allow banks to compete with the tide of swelling financial conglomerates, somehow that was going to be bad for the base of insured deposits covered by the FDIC, and the more things get out from under that insured base, the riskier it is to our economy.

Now, I don't know whether that is true or not, but my point would be, and I am interested in whether or not you would agree with it, that things are going to get out from under the FDIC insurance base, just depending on the kinds of products that are offered, not based on the institutions that offer them.

Mr. CONOVER. Oh, that's absolutely true. I wasn't expressing the concern that those deposits were flowing out of insured deposits. I was simply saying that here we have a situation where, yes, we granted the banks and thrifts the authority to offer these new competitive accounts, but we haven't done anything for them on the other side of the balance sheet.

Their costs have now gone up. It looks like margins are going to be under significant pressure in the future, and we are asking them to compete, with one arm tied behind their back, against other institutions in making loans or in offering products and services on which they can earn fee income. That is the main thing that I am concerned about.

Senator HEINZ. Is it possible that we are simply going through a cycle where with the invention of some new product, whether it's by Sears or Shearson, that there will be a flow into these new products, but there will be a real limitation on that flow and in the cycle of time people will realize there are risks associated with these products, or costs, as well as convenience, perhaps, that are—which risks are not present in banks, by virtue of deposit insurance and the standard of underwriting that we require of banks?

Mr. CONOVER. It's probably true we are looking at a situation in which we find traditional depositor, institutions under competitive pressure, because of increases in technology and a particular economic environment that we have just been through, with very high and volatile interest rates, and because of the marketing ingenuity of certain companies. Frankly, I think this industry—broadly defined, because of technological developments and continuing market innovation—is probably going to be in a state of transition to one degree or another, for at least the next 3 to 5 years, and probably for the next decade. That's why we ought to take a look at the whole framework of laws under which financial services are offered to see if we can update them so that all these different kinds of institutions that were taking advantage of technology can operate in a fair, equitable, and safe framework.

Senator HEINZ. One thing we could do, that might help banks, would at least make them more competitive, might allow them to capture some additional deposits, would be to permit the payment of interest on checking accounts. If we included therewith a preemption on all State usury laws, with respect to agricultural, business, and commercial loans, we would have at least done what we can at that level to deregulate that side of the balance sheet, as well.

Would that be helpful or unhelpful to banks? Would that improve their position, or would that weaken their position if we did those two things?

Mr. CONOVER. I think we ought to allow interest on demand deposits. I think the issue is whether a Federal preemption of State usury laws, for example, would go far enough in helping them overcome the short-term negative impact of paying interest on demand deposits. I am not really sure, but my instincts tell me that's not enough, that they really need new powers.

Senator HEINZ. Most banks, I gather, would like to be able to pay interest on demand deposits; is that correct?

Mr. CONOVER. Oh, I think that's a mixed bag. I think that probably the large banks don't see paying interest on demand deposits as having a major impact on them and would like to do it. I think smaller banks around the country see it simply as an additional cost that they won't have any way to offset. So, as a stand-alone item, they would be against it. That's what I hear in travels around the country and my discussions.

Senator HEINZ. So the answer to my question is, perhaps, although it was less clear, as to what the answer is when combined with that preemption, standing alone, on balance, it would not be perceived as strengthening a bank's abilities to compete.

Mr. CONOVER. I would agree with that; it would not be.

Senator HEINZ. Even though it would make them compete.

Mr. CONOVER. That's correct—but it would hurt their financial performance in the near term. I don't think Federal preemption of usury ceilings is an adequate offset to that.

Senator HEINZ. Now, some people would say that our prohibition on paying interest on demand deposits, is really a Federal subsidy to banks. They get the deposits for free, but they can invest them, and they don't have to pay anything.

Mr. CONOVER. In a sense, that's true, just as regulation Q was a subsidy to banks and was a major source of their profits for some time. But look what regulation Q caused banks to do in a changing economic environment. Today the public has real alternatives, which we didn't have before, to demand deposits. People can go to other institutions and get the functional equivalent of a demand deposit on which they can earn interest. That was not true until recent years.

So, while it may be true that prohibiting interest on demand deposits is a Federal subsidy, if that prohibition continues, you will see the banking industry lose market share over the long term.

CAUSES OF THE PENN SQUARE AND BUTCHER BANK FAILURES

Senator HEINZ. To what extent did the Comptroller have to get involved in Penn Square or the Butcher banks?

Mr. CONOVER. As you know, we were intimately involved in Penn Square, because it was a national bank, and we were the ones who examined it, supervised it, and ultimately closed it. There's a long record on that whole issue.

On the Butcher banks, technically only one of the Butcher banks was a national bank, but a number of them had been national banks in the past.

We and the FDIC and the Fed worked closely together on the Butcher bank issue, first in trying to find out what the problems really were, and then in trying to figure out how to deal with them.

Senator HEINZ. Let's take Penn Square because you were the lead supervisory agency on that. When Penn Square collapsed, was it that somehow the early warning signals, the early warning signs were missed, or was the situation such that it was simply beyond the control of the comptroller to detect and forestall a rapid unraveling?

Mr. CONOVER. I think there were obviously some early warning signs, and it's easy to go back in hindsight and look at particular examinations and make a judgment as to whether we saw something or failed to see it. That's particularly true of the aspect of Penn Square that has turned out to have caused the biggest problem, and that is that they were acting as a merchant bank and sold nearly $2 billion in loan participations to other banks.

So, I think that in a sense, we did a credible job in the Penn Square affair, but that isn't to say there weren't areas where we could have improved our performance.

Senator HEINZ. I wasn't questioning the quality of your work. I was trying to get at why a very substantial worrisome failure took place, and obviously you didn't want it to take place.

Mr. CONOVER. Of course not.

Senator HEINZ. As far as I know, the Comptroller's office did an excellent job, but the failure took place. It's just to try to understand the limits of regulation that I asked the question, because we are being asked, in the Treasury proposal, to, in a sense, allow banks to go very far afield, especially when you consider the underwriting elements of the Treasury proposal, and it's important for the committee to understand, with respect to some recent experience, did the field office of the Comptroller's division down there, did they kind of miss an obvious sign, or is it just fairly hard to detect early warning signs when banks are doing something that they shouldn't be doing.

Mr. CONOVER. I think it's something quite different. Whenever the management of any financial institution—and I don't think it matters whether it's a bank, an insurance company, securities firm or whatever—chooses to operate in flagrant disregard of prudent practices for that industry, and chooses to try to deceive its regulator, either by providing erroneous information or not following the instructions or suggestions of the regulator—I think any management can run any financial institution into the ground and cause it to fail before anyone can do anything about it.

Senator HEINZ. Would you say that the Butcher banks tried to deceive the regulators?

Mr. CONOVER. I would really rather not comment on that. I am not close enough to the specifics of the relationships between the Butcher banks and either the State authorities or the FDIC to make that statement.

Senator HEINZ. It's clearly different from Penn Square?

Mr. CONOVER. I am not sure. I don't know if it's different from Penn Square in that regard.

Senator HEINZ. I have got to tell you I am a little astonished that you would say, after you told us you had worked very closely with the FDIC to help straighten out the Butcher banks, having expressed a very confident opinion about Penn Square, to say you don't know whether there was any hanky-panky or funny business with respect to the Butcher bank.

Mr. CONOVER. Maybe I should clarify. The main problem we were involved in with the FDIC on the Butcher bank was the problem of loan participations being sold to other banks. Picture a situation in which, there are five banks, and every time you examine one bank, it sells all its bad loans one bank to the left, so the banks are always at least one step ahead of the examiners. Since there were banks regulated by all three banking agencies in this case, it was obvious that in order to get a clear picture of what was going on, we had to work together and put a freeze, in effect, on the activities of all of those banks simultaneously so they could be examined and we could find out what their true condition was.

Senator HEINZ. Maybe you can't answer accurately my first question, and maybe the second question I am about to ask has been asked, but I would assume that your experience with Butcher would tell you that if we were to adopt some version of the Treasury proposal, we would have to have with it some super regulator, some consolidated regulatory body, if we were to avoid what you have just described, with respect to the Butcher banks, where they always managed to keep one step ahead of any individual regulator acting alone, and it wasn't until you became, in effect, a super regulator, that you were—for the purpose.

Mr. CONOVER. By acting together. That is correct.

Senator HEINZ. So, therefore, maybe you said this in your testimony, Todd, do you suggest, as Bill Isaac did, that there ought to be one big super regulator?

Mr. CONOVER. We suggested in our proposal to the Bush Task Force that there ought to be a single bank regulatory agency. But the fundamental premise, the fundamental principle under which the broader regulation of financial services ought to take place is one of functional regulation. For example, if there were an insurance——

Senator HEINZ. That sounds like having your cake and eating it too.

Mr. CONOVER. Well, I have a hard time imagining a regulatory agency that would look after one institution's securities activities, insurance activities, real estate activities, and banking or thrift institution activities all in one regulatory agency. That would be a nightmare, and it would also cause a problem of equity in that an insurance company or securities firm that was part of such a holding company would be subject to a different regulator than an independent insurance or securities firm. Eliminating that inequity is one of the goals we are trying to achieve. But I do think, as far as regulating depository institutions is concerned, that there ought to be a single regulator. We will see how that all comes out in our further deliberations on the Bush Task Force.

Senator HEINZ. Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Mr. Conover. We appreciate your being here. We will have additional questions that we would like you to respond to for the record.

[Response to written questions for the record follows:]

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

October 17, 1983

Dear Chairman Garn:

Enclosed are answers to your supplemental questions to my recent testimony before your Committee.

I appreciate the opportunity to expand upon my views on this important topic. I would be happy to answer any further question you or your colleagues might have.

Sincerely,

C. T. Conover
Comptroller of the Currency

Enclosure

The Honorable
Jake Garn
Chairman, Committee on Banking,
  Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

1. Question

The thrust of your testimony seems to be that if banks don't get added power, they will be competitively disadvantaged and seriously weakened, and this will cause problems for the whole financial system.

Let me ask first, is this threat only prospective, or is it here today? For example, do we see a deterioration in banks' interest margins, operating profits, return on capital and assets? Are problem banks increasing, failures up, and holding companies in trouble -- and is this due to lack of asset flexibility?

Answer

Industry averages would indicate that bank performance continues to be strong, although there are signs of weakening. Year-to-year comparisons since 1980 show a consistent decline in net interest margins, profitability, return on assets, and return on equity. Moreover, the number of institutions that are experiencing difficulty is increasing. Our problem bank list is growing almost daily, and the 41 commercial bank failures this year to date is seven more than failed in all of 1982.

However, any deterioration experienced to date is not due to the lack of asset deregulation. Generally the health of the banking system reflects the overall state of the economy. The overall weakness in the economy, coupled with severe problems in certain major industries, has resulted in above average rates of loan losses for many banks.

The particular concern of bank weakening that I expressed in my testimony before your Committee is mostly prospective. My concern is that we are not equipping commercial banks with the needed tools to adjust to interest rate deregulation. Banks have been fortunate in that the major interest rate deregulation has taken place in periods of declining and relatively moderate interest rates. For that reason, the new accounts such as the Money Market Deposit Account did not significantly dampen profitability. However, interest rate deregulation implies that banks must make substantial adjustments to maintain profitability with shrinking interest rate margins. Without the ability to expand into other areas of financial services, banks could face a long-term deterioration of profitability, as well as an erosion of market share as consumers seek combinations of financial services available only outside of the banking system.

2. Question

I noted your strong reaffirmation of the desirability of "retail banks" or "consumer banks" -- banks which do not make commercial loans -- and also your desire to allow continued affiliations between retail banks and securities firms.

Do you believe that such affiliations are really consistent with depository stability, prevention of abuses due to conflicts of interest, and avoiding concentration of resources? Why?

Answer

Yes. Abuses from conflicts of interest or concentrations of economic resources stem from the potential for an insured institution that engages in commercial lending to also own outright, or underwrite securities in, a commercial enterprise. A bank that owns a company might have an incentive to provide it with credit on more favorable terms than an unaffiliated company. A bank that makes loans to and underwrites the securities of a company might have an incentive to shift the risk burden of the company's debt to investors. I happen to believe that these potential abuses could be avoided by means short of prohibiting commercial lending and corporate underwriting or ownership within the same organization. However, by prohibiting depository institutions that do commercial lending from affiliating with either full-service securities firms or nonfinancial business enterprises, as I have proposed, these problems are completely precluded.

In terms of the stability of the depository system I see no threat in allowing broad ownership of consumer banks. On the contrary, stability of the marketplace requires that its participants be provided as much freedom as possible, consistent with federal interests. If there is a market need for these specialized institutions, as I think there is, then they will be successful.

3. Question

In regard to those non-bank banks, let me ask you a hypothetical question. Suppose a securities firm acquired two non-banks -- one which did not make commercial loans and another which did not accept deposits. Would you see any problems with such an arrangement? Wouldn't it raise all the traditional Glass-Steagall concerns about potential conflicts of interest, and safety and soundness?

Answer

I agree that this could raise the legitimate concerns underlying the Glass-Steagall Act. I have not yet issued a charter to an institution that escapes the authority of the Bank Holding Company Act by not accepting demand deposits, because I believe that broad ownership of such an institution could raise problems such as conflict of interest abuses.

My support of the consumer bank concept is consistent with this belief. Under my proposal, institutions that make commercial loans but do not accept demand deposits would not qualify as a consumer bank and thus could not be acquired by full-service securities firms or nonfinancial enterprises.

4. Question

You favor payment of interest on bank reserves. How does nonpayment of interest burden depositories in competition with other firms?

If interest were paid on bank reserves, would you also allow payment of interest on deposits?

Answer

Nonpayment of interest on required reserves is a tax on depository institutions. As financial intermediaries, banks rely primarily on the spread between interest income and interest expense to make a profit. The inability to earn any interest on a portion (12% for transaction accounts) of the deposits they accept limits their overall profitability. When competing with institutions that offer similar financial services but do not face a similar "tax", banks are placed at a competitive disadvantage.

I also favor interest on demand deposits. Allowing the payment of interest on demand deposits is consistent with deposit deregulation, which I support. However, the removal of interest rate ceilings on time and savings deposits has created a need for banks to make adjustments in their business strategies. Banks need asset flexibility to pursue these strategies. Further deposit deregulation, therefore, should only be done in conjunction with further asset deregulation. The payment of interest on reserves would be beneficial to banks. It does not, however, address the fundamental imbalance of continuing to deregulate liabilities without increasing the ability of banks to make adjustments on the other side of the balance sheet.

5. Question

One issue you didn't mention is "usury preemption". Is preemption important to strengthen financial institutions today? If it is desirable, why?

Answer

I support usury preemption. As I discussed in detail in my testimony before your Committee on April 12, 1983, interest rate ceilings do not achieve their desired results. Usury ceilings are not only ineffective at keeping the cost of credit down, they in fact generally harm precisely those they are intended to help by making credit unavailable to less creditworthy borrowers. When usury ceilings require loans to be made at below-market rates, institutions will restrict their in-state lending to those borrowers who are considered the least risky.

Removal of usury ceilings would benefit depository institutions by granting them greater asset pricing flexibility. This is particularly important as institutions face increased pressure on interest margins as deposit interest rate ceilings are eliminated.

6. Question

The Treasury proposal would expand bank real estate development powers, but would it not actually represent a reduction in such powers for Savings and Loans? Is there evidence from the history of thrift activity in this area that the associated risk demands a curtailing of S&L activity in this area?

Answer

The primary intent of S. 1609 in delineating allowable real estate and other activities is to provide equitable rules for all depository institutions, regardless of charter. While real estate development powers would be reduced for savings and loan associations, banks would gain such powers and the allowable activity would be equalized for all depository institutions.

To my knowledge, there is no evidence that thrift activity in the real estate development area has resulted in undue risk. However, thrift involvement is a relatively recent phenomenon, and the success or failure of such investments cannot necessarily be determined in the short run. In general, because real estate development represents a relatively illiquid investment, portfolio limitations are justified, particularly as institutions gain experience in this new area. If over time, it appears that the limitations are unduly restrictive, they could be eased.

7. Question

To what degree is your support of the Treasury proposal contingent upon your belief that the "separate subsidiaries" scheme provides adequate assurances of stability?

If this scheme does provide adequate protection against risk, why is it then necessary to impose further protection, in the form of restrictions on investment in real estate development, or restrictions on types of underwriting activities?

Answer

The separate subsidiaries approach in S. 1609 has merit from a regulatory point of view. The effective regulation of each activity is facilitated and the safety of the insured deposits is enhanced. It also has merit from a business standpoint.

However, there are no assurances that these new activities, or any currently allowable activities for that matter, will never be pursued in a way that will increase the riskiness of some banks. Restrictions on the extent of involvement in these activities, particularly during the first few years, are justified in that they will help limit this risk.

Let me announce that there will be additional hearings on these bills, but not this month, as we have a very full schedule of hearings. I will run through them briefly. This afternoon Senator Heinz, as the Chairman of the International Finance Subcommittee, will conduct hearings on the Export-Import Bank's proposal to offer a line of credit to Brazil and Mexico.

We will have full committee hearings on extension of the Defense Production Act tomorrow; hearings on the nomination of Philip Abrams to be Under Secretary of HUD on Friday, September 16.

Full committee hearings on Monday, September 19, at 10 a.m. and 2 p.m., on S. 1679, the Honest Budgeting Act of 1983. That title worries me, whenever you see a title like that, it starts to worry you.

Senator HEINZ. If it worries us, Mr. Chairman, think how the people must feel.

The CHAIRMAN. September 21, Housing and Urban Affairs Subcommittee; on September 22, we will hold hearings, Consumer Affairs Subcommittee on September 28, and the Housing and Urban Affairs Subcommittee on September 29. We have a very full schedule for the remainder of September.

Senator HEINZ. Mr. Chairman, may I ask one question? Did the rest of the members of the committee do something to offend you?

The CHAIRMAN. No; we just have a lot of things to do, but we will be back, for those who are interested in hearings on these issues that we have been discussing these last few days early in October. Thank you very much. The committee is adjourned.

[Whereupon, at 11:58 a.m., the hearing was recessed.]

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